AUTHENTICATED
U.S. GOVERNMENT
INFORMATION
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Title 26—Internal Revenue

(This book contains part 1, §§ 1.851 to 1.907)

Part

CHAPTER I—Internal Revenue Service, Department of the Treasury (Continued) 1

CHAPTER I—INTERNAL REVENUE SERVICE, DEPARTMENT OF THE TREASURY (CONTINUED)

SUBCHAPTER A—INCOME TAX (CONTINUED)

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SUPPLEMENTARY PUBLICATION: *Internal Revenue Service Looseleaf Regulations System.*

Additional supplementary publications are issued covering *Alcohol and Tobacco Tax Regulations* and *Regulations Under Tax Conventions.*

SUBCHAPTER A—INCOME TAX (CONTINUED)

PART 1—INCOME TAXES (CONTINUED)

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AUTHORITY: 26 U.S.C. 7805.

Sections 1.851–3 and 1.851–5 are also issued under 26 U.S.C. 851(c).

Section 1.852–11 is also issued under 26 U.S.C. 852(b)(3)(C), 852(b)(8), and 852(c).

Section 1.853–1 also issued under 26 U.S.C. 901(j).

Section 1.853–2 also issued under 26 U.S.C. 901(j).

Section 1.853–3 also issued under 26 U.S.C. 901(j).

Section 1.853–4 also issued under 26 U.S.C. 901(j) and 26 U.S.C. 6011.

Section 1.860A–0 also issued under 26 U.S.C. 860G(e).

Section 1.860A–1 also issued under 26 U.S.C. 860G(b) and 860G(e).

Section 1.860D–1 also issued under 26 U.S.C. 860G(e).

Section 1.860E–1 also issued under 26 U.S.C. 860E and 860G(e).

Section 1.860E–2 also issued under 26 U.S.C. 860E(e).

Section 1.860F–2 also issued under 26 U.S.C. 860G(e).

Section 1.860F–4 also issued under 26 U.S.C. 860G(e) and 26 U.S.C. 6230(k).

Section 1.860F–4T also issued under 26 U.S.C. 860G(c)(3) and (e).

Section 1.860G–1 also issued under 26 U.S.C. 860G(a)(1)(B) and (e).

Section 1.860G–2 also issued under 26 U.S.C. 860G(e).

Section 1.860G–3 also issued under 26 U.S.C. 860G(b) and 26 U.S.C. 860G(e).

Section 1.861–2 also issued under 26 U.S.C. 863(a).

Section 1.861–3 also issued under 26 U.S.C. 863(a).

Section 1.861–8 also issued under 26 U.S.C. 882(c).

Sections 1.861–9 and 1.861–9T also issued under 26 U.S.C. 863(a), 26 U.S.C. 864(e), 26 U.S.C. 865(i), and 26 U.S.C 7701(f).

Section 1.861–10(e) also issued under 26 U.S.C. 863(a), 26 U.S.C. 864(e), 26 U.S.C. 865(i) and 26 U.S.C. 7701(f).

Section 1.861–11 also issued under 26 U.S.C. 863(a), 26 U.S.C. 864(e), 26 U.S.C. 865(i), and 26 U.S.C. 7701(f).

Section 1.861–14 also issued under 26 U.S.C. 863(a), 26 U.S.C. 864(e), 26 U.S.C. 865(i), and 26 U.S.C. 7701(f).

Sections 1.861–8T through 1.861–14T also issued under 26 U.S.C. 863(a), 26 U.S.C. 864(e), 26 U.S.C. 865(i) and 26 U.S.C. 7701(f).

Section 1.863–1 also issued under 26 U.S.C. 863(a).

Section 1.863–2 also issued under 26 U.S.C. 863.

Section 1.863–3 also issued under 26 U.S.C. 863(a) and (b), and 26 U.S.C. 936(h).

Section 1.863–4 also issued under 26 U.S.C. 863.

Section 1.863–6 also issued under 26 U.S.C. 863.

Section 1.863–7 also issued under 26 U.S.C. 863(a) and 871(m).

Section 1.863–8 also issued under 26 U.S.C. 863(a), (b) and (d).

Section 1.863–9 also issued under 26 U.S.C. 863(a), (d) and (e).

Section 1.864–5 also issued under 26 U.S.C. 7701(l).

Section 1.864–8T also issued under 26 U.S.C. 864(d)(8).

Section 1.865–1 also issued under 26 U.S.C. 863(a) and 865(j)(1).

Section 1.865–2 also issued under 26 U.S.C. 863(a) and 865(j)(1).

Section 1.871–1 also issued under 26 U.S.C. 7701(l).

Section 1.871–7 also issued under 26 U.S.C. 7701(l).

Section 1.871–9 also issued under 26 U.S.C. 7701(b)(11).

Section 1.871–15 also issued under 26 U.S.C. 871(m).

Section 1.874–1 also issued under 26 U.S.C. 874.

Section 1.881–2 also issued under 26 U.S.C. 7701(l).

Section 1.881–3 also issued under 26 U.S.C. 7701(l).

Section 1.881–4 also issued under 26 U.S.C. 7701(l).

Section 1.882–4 also issued under 26 U.S.C. 882(c).

Section 1.882–5 also issued under 26 U.S.C. 882, 26 U.S.C. 864(e), 26 U.S.C. 988(d), and 26 U.S.C. 7701(l).

Section 1.883–1 is also issued under 26 U.S.C. 883.
Section 1.883–2 is also issued under 26 U.S.C. 883.
Section 1.883–3 is also issued under 26 U.S.C. 883.
Section 1.883–4 is also issued under 26 U.S.C. 883.
Section 1.883–5 is also issued under 26 U.S.C. 883.
Section 1.884–0 also issued under 26 U.S.C. 884 (g).
Section 1.884–1 also issued under 26 U.S.C. 884.
Section 1.884–1 also issued under 26 U.S.C. 884 (g).
Section 1.884–1 (d) also issued under 26 U.S.C. 884 (c) (2) (A).
Section 1.884–1 (d) (13) (i) also issued under 26 U.S.C. 884 (c) (2).
Section 1.884–1 (e) also issued under 26 U.S.C. 884 (c) (2) (B).
Section 1.884–2 also issued under 26 U.S.C. 884(g).
Section 1.884–2T also issued under 26 U.S.C. 884 (g).
Section 1.884–4 also issued under 26 U.S.C. 884 (g).
Section 1.884–5 also issued under 26 U.S.C. 884 (g).
Section 1.884–5 (e) and (f) also issued under 26 U.S.C. 884 (e) (4) (C).
Section 1.892–1T also issued under 26 U.S.C. 892(c).
Section 1.892–2T also issued under 26 U.S.C. 892(c).
Section 1.892–3T also issued under 26 U.S.C. 892(c).
Section 1.892–4T also issued under 26 U.S.C. 892(c).
Section 1.892–5 also issued under 26 U.S.C. 892(c).
Section 1.892–5T also issued under 26 U.S.C. 892(c).
Section 1.892–6T also issued under 26 U.S.C. 892(c).
Section 1.892–7T also issued under 26 U.S.C. 892(c).
Section 1.894–1 also issued under 26 U.S.C. 894 and 7701(l).
Sections 1.897–5T, 1.897–6T and 1.897–7T also issued under 26 U.S.C. 897 (d), (e), (g) and (j) and 26 U.S.C. 367(e)(2).
Sections 1.902–1 and 902–2 also issued under 26 U.S.C. 902(c)(7).
Section 1.904–4 also issued under 26 U.S.C. 904(d)(6).
Section 1.904–5 also issued under 26 U.S.C. 904(d)(6).
Section 1.904–6 also issued under 26 U.S.C. 904(d)(6).
Section 1.904–7 also issued under 26 U.S.C. 904(d)(6).
Section 1.904(b)–1 also issued under 26 U.S.C. 1(h)(11)(C)(iv) and 904(b)(2)(C).
Section 1.904(b)–2 also issued under 26 U.S.C. 1(h)(11)(C)(iv) and 904(b)(2)(C).
Section 1.904(f)–(2) also issued under 26 U.S.C. 904 (f)(3)(b).
Section 1.904(g)–3T also issued under 26 U.S.C. 904(g)(4).
Section 1.904(i)–1 also issued under 26 U.S.C. 904(i).
Sections 1.905–3T and 1.905–4T also issued under 26 U.S.C. 989(c)(4).
Section 1.907(b)–1 is also issued under 26 U.S.C. 907(b).
Section 1.907(b)–1T also issued under 26 U.S.C. 907(b).

SOURCE: T.D. 6500, 25 FR 11910, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, unless otherwise noted.

REGULATED INVESTMENT COMPANIES AND REAL ESTATE INVESTMENT TRUSTS

§ 1.851–1 Definition of regulated investment company.

(a) *In general.* The term ''regulated investment company'' is defined to mean any domestic corporation (other than a personal holding company as defined in section 542) which meets (1) the requirements of section 851(a) and paragraph (b) of this section, and (2) the limitations of section 851(b) and § 1.851–2. As to the definition of the term ''corporation'', see section 7701(a)(3).

(b) *Requirement.* To qualify as a regulated investment company, a corporation must be:

(1) Registered at all times during the taxable year, under the Investment Company Act of 1940, as amended (15 U.S.C. 80a–1 to 80b–2), either as a management company or a unit investment trust, or

(2) A common trust fund or similar fund excluded by section 3(c)(3) of the Investment Company Act of 1940 (15 U.S.C. 80a–3(c)) from the definition of ''investment company'' and not included in the definition of ''common trust fund'' by section 584(a).

§ 1.851–2 Limitations.

(a) *Election to be a regulated investment company.* Under the provisions of section 851(b)(1), a corporation, even though it satisfies the other requirements of part I, subchapter M, chapter 1 of the Code, for the taxable year, will not be considered a regulated investment company for such year, within the meaning of such part I, unless it elects to be a regulated investment

company for such taxable year, or has made such an election for a previous taxable year which began after December 31, 1941. The election shall be made by the taxpayer by computing taxable income as a regulated investment company in its return for the first taxable year for which the election is applicable. No other method of making such election is permitted. An election once made is irrevocable for such taxable year and all succeeding taxable years.

(b) *Gross income requirement*—(1) *General rule.* Section 851(b) (2) and (3) provides that (i) at least 90 percent of the corporation's gross income for the taxable year must be derived from dividends, interest, and gains from the sale or other disposition of stocks or securities, and (ii) less than 30 percent of its gross income must have been derived from the sale or other disposition of stock or securities held for less than three months. In determining the gross income requirements under section 851(b) (2) and (3), a loss from the sale or other disposition of stock or securities does not enter into the computation. A determination of the period for which stock or securities have been held shall be governed by the provisions of section 1223 insofar as applicable.

(2) *Special rules.* (i) For purposes of section 851(b)(2), there shall be treated as dividends amounts which are included in gross income for the taxable year under section 951(a)(1)(A)(i) to the extent that (*a*) a distribution out of a foreign corporation's earnings and profits of the taxable year is not included in gross income by reason of section 959 (a)(1), and (*b*) the earnings and profits are attributable to the amounts which were so included in gross income under section 951(a)(1)(A)(i). For allocation of distributions to earnings and profits of foreign corporations, see §1.959–3. The provisions of this subparagraph shall apply with respect to taxable years of controlled foreign corporations beginning after December 31, 1975, and to taxable years of United States shareholders (within the meaning of section 951(b) within which or with which such taxable years of such controlled foreign corporations end.

(ii) For purposes of subdivision (i) of this subparagraph, if by reason of section 959(a)(1) a distribution of a foreign corporation's earnings and profits for a taxable year described in section 959(c)(2) is not included in a shareholder's gross income, then such distribution shall be allocated proportionately between amounts attributable to amounts included under each clause of section 951(a)(1)(A). Thus, for example, M is a United States shareholder in X Corporation, a controlled foreign corporation. M and X each use the calendar year as the taxable year. For 1977, M is required by section 951(a)(1)(a) to include $3,000 in its gross income, $1,000 of which is included under clause (i) thereof. In 1977, M received a distribution described in section 959(c)(2) of $2,700 out of X's earnings and profits for 1977, which is, by reason of section 959(a)(1), excluded from M's gross income. The amount of the distribution attributable to the amount included under section 951(a)(1)(A)(i) is $900, i.e., $2,700 multiplied by ($1,000/$3,000).

(c) *Diversification of investments.* (1) Subparagraph (A) of section 851(b)(4) requires that at the close of each quarter of the taxable year at least 50 percent of the value of the total assets of the taxpayer corporation be represented by one or more of the following:

(i) Cash and cash items, including receivables;

(ii) Government securities;

(iii) Securities of other regulated investment companies; or

(iv) Securities (other than those described in subdivisions (ii) and (iii) of this subparagraph) of any one or more issuers which meet the following limitations: (*a*) The entire amount of the securities of the issuer owned by the taxpayer corporation is not greater in value than 5 percent of the value of the total assets of the taxpayer corporation, and (*b*) the entire amount of the securities of such issuer owned by the taxpayer corporation does not represent more than 10 percent of the outstanding voting securities of such issuer. For the modification of the percentage limitations applicable in the case of certain venture capital investment companies, see section 851(e) and §1.851–6.

Assuming that at least 50 percent of the value of the total assets of the corporation satisfies the requirements specified in this subparagraph, and that the limiting provisions of subparagraph (B) of section 851(b)(4) and subparagraph (2) of this paragraph are not violated, the corporation will satisfy the requirements of section 851(b)(4), notwithstanding that the remaining assets do not satisfy the diversification requirements of subparagraph (A) of section 851(b)(4). For example, a corporation may own all the stock of another corporation, provided it otherwise meets the requirements of subparagraphs (A) and (B) of section 851(b)(4).

(2) Subparagraph (B) of section 851(b)(4) prohibits the investment at the close of each quarter of the taxable year of more than 25 percent of the value of the total assets of the corporation (including the 50 percent or more mentioned in subparagraph (A) of section 851(b)(4)) in the securities (other than Government securities or the securities of other regulated investment companies) of any one issuer, or of two or more issuers which the taxpayer company controls and which are engaged in the same or similar trades or businesses or related trades or businesses, including such issuers as are merely a part of a unit contributing to the completion and sale of a product or the rendering of a particular service. Two or more issuers are not considered as being in the same or similar trades or businesses merely because they are engaged in the broad field of manufacturing or of any other general classification of industry, but issuers shall be construed to be engaged in the same or similar trades or businesses if they are engaged in a distinct branch of business, trade, or manufacture in which they render the same kind of service or produce or deal in the same kind of product, and such service or products fulfill the same economic need. If two or more issuers produce more than one product or render more than one type of service, then the chief product or service of each shall be the basis for determining whether they are in the same trade or business.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 6598, 27 FR 4090, Apr. 28, 1962; T.D. 7555, 43 FR 32753, July 28, 1978]

§ 1.851–3 Rules applicable to section 851(b)(3).

(a) *In general.* In determining the value of the taxpayer's investment in the securities of an issuer, for purposes of subparagraph (B) of section 851(b)(3), there shall be included its proper proportion of the investment of any other corporation, a member of a controlled group, in the securities of such issuer. *See Example 4* in § 1.851–5. For purposes of §§ 1.851–2, 1.851–4, 1.851–5, and 1.851–6, the terms ''controls,'' ''controlled group,'' and ''value'' have the meaning assigned to them by section 851(c). All other terms used in these sections have the same meaning as when used in the Investment Company Act of 1940 (15 U.S.C., chapter 2D), as amended.

(b) *Effective/applicability dates.* The rules of this section apply to quarters that begin on or after December 14, 2015. For purposes of applying the first sentence of section 851(d)(1) to a quarter that begins on or after March 14, 2016, the rules of this section apply in determining whether the taxpayer met the requirements of section 851(b)(3) and (c) at the close of prior quarters.

[T.D. 9737, 80 FR 55245, Sept. 15, 2015]

§ 1.851–4 Determination of status.

With respect to the effect which certain discrepancies between the value of its various investments and the requirements of section 851(b)(4) and paragraph (c) of § 1.851–2, or the effect that the elimination of such discrepancies will have on the status of a company as a regulated investment company for purposes of part I, subchapter M, chapter 1 of the Code, see section 851(d). A company claiming to be a regulated investment company shall keep sufficient records as to investments so as to be able to show that it has complied with the provisions of section 851 during the taxable year. Such records shall be kept at all times available for inspection by any internal revenue officer or employee and shall be retained

so long as the contents thereof may become material in the administration of any internal revenue law.

[T.D. 6598, 27 FR 4090, Apr. 28, 1962]

§ 1.851–5 Examples.

(a) *Examples*. The provisions of section 851 may be illustrated by the following examples:

Example 1. (i) Investment Company W at the close of its first quarter of its taxable year has its assets invested as follows:

	Percent
Cash	5
Government securities	10
Securities of regulated investment companies	20
Securities of Corporation A	10
Securities of Corporation B	15
Securities of Corporation C	20
Securities of various corporations (not exceeding 5 percent of its assets in any one company)	20
Total	100

(ii) Investment Company W owns all of the voting stock of Corporations A and B, 15 percent of the voting stock of Corporation C, and less than 10 percent of the voting stock of regulated investment companies and various other corporations. Neither Corporation A nor Corporation B owns:

(A) 20 percent or more of the voting stock of any other corporation;

(B) Securities issued by Corporation C; or

(C) Securities issued by any of the regulated investment companies or various corporations whose securities are owned by Investment Company W. Except for Corporation A and Corporation B, none of the corporations (including the regulated investment companies) is a member of a controlled group with Investment Company W.

(iii) Investment Company W meets the requirements under section 851(b)(3) at the end of its first quarter. It complies with subparagraph (A) of section 851(b)(3) because it has 55 percent of its assets invested as provided in that subparagraph. It complies with subparagraph (B) of section 851(b)(3) because it does not have more than 25 percent of its assets invested in the securities of any one issuer, of two or more issuers that it controls, or of one or more qualified publicly traded partnerships (as defined in section 851(h)).

Example 2. (i) Investment Company V at the close of a particular quarter of the taxable year has its assets invested as follows:

	Percent
Cash	10
Government securities	35
Securities of Corporation A	7
Securities of Corporation B	12
Securities of Corporation C	15
Securities of Corporation D	21
Total	100

(ii) Investment Company V fails to meet the requirements of subparagraph (A) of section 851(b)(3) since its assets invested in Corporations A, B, C, and D exceed in each case 5 percent of the value of the total assets of the company at the close of the particular quarter.

Example 3. (i) Investment Company X at the close of a particular quarter of the taxable year has its assets invested as follows:

	Percent
Cash and Government securities	20
Securities of Corporation A	5
Securities of Corporation B	10
Securities of Corporation C	25
Securities of various corporations (not exceeding 5 percent of its assets in any one company)	40
Total	100

(ii) Investment Company X owns more than 20 percent of the voting power of Corporations B and C and less than 10 percent of the voting power of all of the other corporations. Corporation B manufactures radios and Corporation C acts as its distributor and also distributes radios for other companies. Investment Company X fails to meet the requirements of subparagraph (B) of section 851(b)(3) since it has 35 percent of its assets invested in the securities of two issuers which it controls and which are engaged in related trades or businesses.

Example 4. (i) Investment Company Y at the close of a particular quarter of its taxable year has its assets invested as follows:

	Percent
Cash and Government securities	15
Securities of Corporation K (a regulated investment company)	30
Securities of Corporation A	10
Securities of Corporation B	20
Securities of various corporations (not exceeding 5 percent of its assets in any one company)	25
Total	100

(ii) Corporation K has 20 percent of its assets invested in Corporation L, and Corporation L has 40 percent of its assets invested in Corporation B. Corporation A also has 30 percent of its assets invested in Corporation B. Investment Company Y owns more than 20 percent of the voting power of Corporations A and K. Corporation K owns more than 20 percent of the voting power of Corporation L.

(iii) At the end of that quarter, Investment Company Y is disqualified under subparagraph (B)(i) of section 851(b)(3) because, after applying section 851(c)(1), more than 25 percent of the value of Investment Company Y's total assets is invested in the securities of Corporation B. This result is shown by the following calculation:

	Percent
Percentage of assets invested directly in Corporation B	20.0
Percentage invested indirectly through K and L (30% × 20% × 40%)	2.4
Percentage invested indirectly through A (10% × 30%)	3.0
Total percentage of assets of Investment Company Y invested in Corporation B	25.4

Example 5. Investment Company Z, which keeps its books and makes its returns on the basis of the calendar year, at the close of the first quarter of 2016 meets the requirements of section 851(b)(3) and has 20 percent of its assets invested in Corporation A. Later during the taxable year it makes distributions to its shareholders and because of such distributions, it finds at the close of the taxable year that it has more than 25 percent of its remaining assets invested in Corporation A. Investment Company Z does not lose its status as a regulated investment company for the taxable year 2016 because of such distributions, nor will it lose its status as a regulated investment company for any subsequent year solely as a result of such distributions. *See* section 851(d)(1).

Example 6. Investment Company Q, which keeps its books and makes its returns on the basis of the calendar year, at the close of the first quarter of 2016 meets the requirements of section 851(b)(3) and has 20 percent of its assets invested in Corporation P. At the close of the taxable year 2016, it finds that it has more than 25 percent of its assets invested in Corporation P. This situation results entirely from fluctuations in the market values of the securities in Investment Company Q's portfolio and is not due in whole or in part to the acquisition of any security or other property. Investment Company Q does not lose its status as a regulated investment company for the taxable year 2016 because of such fluctuations in the market values of the securities in its portfolio, nor will it lose its status as a regulated investment company for any subsequent year solely as a result of such market value fluctuations. *See* section 851(d)(1).

Example 7. (i) Investment Company T at the close of a particular quarter of its taxable year has its assets invested as follows:

	Percent
Cash and Government securities	40
Securities of Corporation A	20
Securities of various qualified publicly traded partnerships (within the meaning of sections 851(b)(3) and 851(h))	15
Securities of various corporations (not exceeding 5 percent of its assets in any one company)	25
Total	100

(ii) Investment Company T owns more than 20 percent of the voting power of Corporation A and less than 10 percent of the voting power of all of the other corporations. Corporation A has 80 percent of its assets invested in qualified publicly traded partnerships.

(iii) Investment Company T is disqualified under subparagraph (B)(iii) of section 851(b)(3), because, after applying section 851(c)(1), more than 25 percent of the value of Investment Company T's total assets is invested in the securities of one or more qualified publicly traded partnerships. This result is shown by the following calculation:

	Percent
Percentage of assets invested directly in qualified publicly traded partnerships	15.0
Percentage invested in qualified publicly traded partnerships indirectly through A (20% × 80%)	16.0
Total percentage of assets of Investment Company T invested in qualified publicly traded partnerships	31.0

(b) *Effective/applicability dates*. The rules of this section apply to quarters that begin on or after December 14, 2015. For purposes of applying the first sentence of section 851(d)(1) to a quarter that begins on or after March 14, 2016, the rules of this section apply in determining whether the taxpayer met the requirements of section 851(b)(3) and (c) at the close of prior quarters.

[T.D. 9737, 80 FR 55245, Sept. 15, 2015]

§ 1.851–6 Investment companies furnishing capital to development corporations.

(a) *Qualifying requirements*. (1) In the case of a regulated investment company which furnishes capital to development corporations, section 851 (e) provides an exception to the rule relating to the diversification of investments, made applicable to regulated investment companies by section 851(b)(4)(A). This exception (as provided in paragraph (b) of this section) is available only to registered management investment companies which the Securities and Exchange Commission

determines, in accordance with regulations issued by it, and certifies to the Secretary or his delegate, not earlier than 60 days before the close of the taxable year of such investment company, to be principally engaged in the furnishing of capital to other corporations which are principally engaged in the development or exploitation of inventions, technological improvements, new processes, or products not previously generally available.

(2) For the purpose of the aforementioned determination and certification, unless the Securities and Exchange Commission determines otherwise, a corporation shall be considered to be principally engaged in the development or exploitation of inventions, technological improvements, new processes, or products not previously generally available, for at least 10 years after the date of the first acquisition of any security in such corporation or any predecessor thereof by such investment company if at the date of such acquisition the corporation or its predecessor was principally so engaged, and an investment company shall be considered at any date to be furnishing capital to any company whose securities it holds if within 10 years before such date it had acquired any of such securities, or any securities surrendered in exchange therefor, from such other company or its predecessor.

(b) *Exception to general rule.* (1) The registered management investment company, which for the taxable year meets the requirements of paragraph (a) of this section, may (subject to the limitations of section 851(e)(2) and paragraph (c) of this section) in the computation of 50 percent of the value of its assets under section 851(b)(4)(A) and paragraph (c)(1) of §1.851–2 for any quarter of such taxable year, include the value of any securities of an issuer (whether or not the investment company owns more than 10 percent of the outstanding voting securities of such issuer) if at the time of the latest acquisition of any securities of such issuer the basis of all such securities in the hands of the investment company does not exceed 5 percent of the value of the total assets of the investment company at that time. The exception provided by section 851(e)(1) and this subparagraph is not applicable to the securities of an issuer if the investment company has continuously held any security of such issuer or of any predecessor company (as defined in paragraph (d) of this section) for 10 or more years preceding such quarter of the taxable year. The rule of section 851(e)(1) with respect to the relationship of the basis of the securities of an issuer to the value of the total assets of the investment company is, in substance, a qualification of the 5-percent limitation in section 851(b)(4)(A)(ii) and paragraph (c)(1)(iv) of §1.851–2. All other provisions and requirements of section 851 and §§1.851–1 through 1.851–6 are applicable in determining whether such registered management investment company qualifies as a regulated investment company.

(2) The application of subparagraph (1) of this paragraph may be illustrated by the following examples:

Example 1. (i) The XYZ Corporation, a regulated investment company, qualified under section 851(e) as an investment company furnishing capital to development corporations. On June 30, 1954, the XYZ Corporation purchased 1,000 shares of the stock of the A Corporation at a cost of $30,000. On June 30, 1954, the value of the total assets of the XYZ Corporation was $1,000,000. Its investment in the stock of the A Corporation ($30,000) comprised 3 percent of the value of its total assets, and it therefore met the requirements prescribed by section 851(b)(4)(A)(ii) as modified by section 851(e)(1).

(ii) On June 30, 1955, the value of the total assets of the XYZ Corporation was $1,500,000 and the 1,000 shares of stock of the A Corporation which the XYZ Corporation owned appreciated in value so that they were then worth $60,000. On that date, the XYZ Investment Company increased its investment in the stock of the A Corporation by the purchase of an additional 500 shares of that stock at a total cost of $30,000. The securities of the A Corporation owned by the XYZ Corporation had a value of $90,000 (6 percent of the value of the total assets of the XYZ Corporation) which exceeded the limit provided by section 851(b)(4)(A)(ii). However, the investment of the XYZ Corporation in the A Corporation on June 30, 1955, qualified under section 851(b)(4)(A) as modified by section 851(e)(1), since the basis of those securities to the investment company did not exceed 5 percent of the value of its total assets as of June 30, 1955, illustrated as follows:

Basis to the XYZ Corporation of the A Corporation's stock acquired on June 30, 1954	$30,000

Basis of the 500 shares of the A Corporation's stock acquired by the XYZ Corporation on June 30, 1955	30,000
Basis of all stock of A Corporation	60,000

Basis of stock of A Corporation ($60,000)/Value of XYZ Corporation's total assets at June 30, 1955, time of the latest acquisition ($1,500,000) = 4 percent

Example 2. The same facts existed as in example 1, except that on June 30, 1955, the XYZ Corporation increased its investment in the stock of the A Corporation by the purchase of an additional 1,000 shares of that stock (instead of 500 shares) at a total cost of $60,000. No part of the investment of the XYZ Corporation in the A Corporation qualified under the 5 percent limitation provided by section 851(b)(4)(A) as modified by section 851(e)(1), illustrated as follows:

Basis to the XYZ Corporation of the 1,000 shares of the A Corporation's stock acquired on June 30, 1954	$30,000
Basis of the 1,000 shares of the A Corporation's stock acquired on June 30, 1955	60,000
Total	90,000

Basis of stock of A Corporation ($90,000)/Value of XYZ Corporation's total assets at June 30, 1955, time of the latest acquisition ($1,500,000)= 6 percent

Example 3. The same facts existed as in example 2 and on June 30, 1956, the XYZ Corporation increased its investment in the stock of the A Corporation by the purchase of an additional 100 shares of that stock at a total cost of $6,000. On June 30, 1956, the value of the total assets of the XYZ Corporation was $2,000,000 and on that date the investment in the A Corporation qualified under section 851(b)(4)(A) as modified by section 851(e)(1) illustrated as follows:

Basis to the XYZ Corporation of investments in the A Corporation's stock:	
1,000 shares acquired June 30, 1954	$30,000
1,000 shares acquired June 30, 1955	60,000
100 shares acquired June 30, 1956	6,000
Total	96,000

Basis of stock of A Corporation ($96,000)/Value of XYZ Corporation's total assets at June 30, 1956, time of the latest acquisition ($2,000,000) = 4.8 percent

(c) *Limitation.* Section 851(e) and this section do not apply in the quarterly computation of 50 percent of the value of the assets of an investment company under subparagraph (A) of section 851(b)(4) and paragraph (c)(1) of § 1.851–2 for any taxable year if at the close of any quarter of such taxable year more than 25 percent of the value of its total assets (including the 50 percent or more mentioned in such subparagraph (A)) is represented by securities (other than Government securities or the securities of other regulated investment companies) of issuers as to each of which such investment company (1) holds more than 10 percent of the outstanding voting securities of such issuer, and (2) has continuously held any security of such issuer (or any security of a predecessor of such issuer) for 10 or more years preceding such quarter, unless the value of its total assets so represented is reduced to 25 percent or less within 30 days after the close of such quarter.

(d) *Definition of predecessor company.* As used in section 851(e) and this section, the term ''predecessor company'' means any corporation the basis of whose securities in the hands of the investment company was, under the provisions of section 358 or corresponding provisions of prior law, the same in whole or in part as the basis of any of the securities of the issuer and any corporation with respect to whose securities any of the securities of the issuer were received directly or indirectly by the investment company in a transaction or series of transactions involving nonrecognition of gain or loss in whole or in part. The other terms used in this section have the same meaning as when used in section 851(b)(4). See paragraph (c) of § 1.851–2 and § 1.851–3.

§ 1.851–7 Certain unit investment trusts.

(a) *In general.* For purposes of the Internal Revenue Code, a unit investment trust (as defined in paragraph (d) of this section) shall not be treated as a person (as defined in section 7701(a)(1)) except for years ending before January 1, 1969. A holder of an interest in such a trust will be treated as directly owning the assets of such trust for taxable years of such holder which end with or within any year of the trust to which section 851(f) and this section apply.

(b) *Treatment of unit investment trust.* A unit investment trust shall not be treated as an individual, a trust estate, partnership, association, company, or corporation for purposes of the Internal Revenue Code. Accordingly, a unit investment trust is not a taxpayer subject to taxation under the Internal Revenue Code. No gain or loss will be

recognized by the unit investment trust if such trust distributes a holder's proportionate share of the trust assets in exchange for his interest in the trust. Also, no gain or loss will be recognized by the unit investment trust if such trust sells the holder's proportionate share of the trust assets and distributes the proceeds from such share to the holder in exchange for his interest in the trust.

(c) *Treatment of holder of interest in unit investment trust.* (1) Each holder of an interest in a unit investment trust shall be treated (to the extent of such interest) as owning a proportionate share of the assets of the trust. Accordingly, if the trust distributes to the holder of an interest in such trust his proportionate share of the trust assets in exchange for his interest in the trust, no gain or loss shall be recognized by such holder (or by any other holder of an interest in such trust). For purposes of this paragraph, each purchase of an interest in the trust by the holder will be considered a separate interest in the trust. Items of income, gain, loss, deduction, or credit received by the trust or a custodian thereof shall be taxed to the holders of interests in the trust (and not to the trust) as though they had received their proportionate share of the items directly on the date such items were received by the trust or custodian.

(2) The basis of the assets of such trust which are treated under subparagraph (1) of this paragraph as being owned by the holder of an interest in such trust shall be the same as the basis of his interest in such trust. Accordingly, the amount of the gain or loss recognized by the holder upon the sale by the unit investment trust of the holder's pro rata share of the trust assets shall be determined with reference the basis, of his interest in the trust. Also, the basis of the assets received by the holder, if the trust distributes a holder's pro rata share of the trust assets in exchange for his interest in the trust, will be the same as the basis of his interest in the trust. If the unit investment trust sells less than all of the holder's pro rata share of the trust assets and the holder retains an interest in the trust, the amount of the gain or loss recognized by the holder upon the sale shall be determined with reference to the basis of his interest in the assets sold by the trust, and the basis of his interest in the trust shall be reduced accordingly. If the trust distributes a portion of the holder's pro rata share of the trust assets in exchange for a portion of his interest in the trust, the basis of the assets received by the holder shall be determined with reference to the basis of his interest in the assets distributed by the trust, and the basis of his interest in the trust shall be reduced accordingly. For purposes of this subparagraph the basis of the holder's interest in assets sold by the trust or distributed to him shall be an amount which bears the same relationship to the basis of his total interest in the trust that the fair market value of the assets so sold or distributed bears to the fair market value of such total interest in the trust, such fair market value to be determined on the date of such sale or distribution.

(3) The period for which the holder of an interest in such trust has held the assets of the trust which are treated under subparagraph (1) of this paragraph as being owned by him is the same as the period for which such holder has held his interest in such trust. Accordingly, the character of the gain, loss, deduction, or credit recognized by the holder upon the sale by the unit investment trust of the holder's proportionate share of the trust assets shall be determined with reference to the period for which he has held his interest in the trust. Also, the holding period of the assets received by the holder if the trust distributes the holder's proportionate share of the trust assets in exchange for his interest in the trust will include the period for which the holder has held his interest in the trust.

(4) The application of the provisions of this paragraph may be illustrated by the following example:

Example. B entered a periodic payment plan of a unit investment trust (as defined in paragraph (d) of this section) with X Bank as custodian and Z as plan sponsor. Under this plan, upon B's demand, X must either redeem B's interest at a price substantially equal to the fair market value of the number of shares in Y, a management company, which are credited to B's account by X in connection with the unit investment trust,

or at B's option distribute such shares of Y to B. B's plan provides for quarterly payments of $1,000. On October 1, 1969, B made his initial quarterly payment of $1,000 and X credited B's account with 110 shares of Y. On December 1, 1969, Y declared and paid a dividend of 25 cents per share, 5 cents of which was designated as a capital gain dividend pursuant to section 852(b)(3) and §1.852–4. X credited B's account with $27.50 but did not distribute the money to B in 1969. On December 31, 1969, X charged B's account with $1 for custodial fees for calendar year 1969. On January 1, 1970, B paid X $1,000 and X credited B's account with 105 shares of Y. On April 1, 1970, B paid X $1,000 and X credited B's account with 100 shares of Y. B must include in his tax return for 1969 a dividend of $22 and a long-term capital gain of $5.50. In addition, B is entitled to deduct the annual custodial fee of $1 under section 212 of the Code.

(a) On April 4, 1970, at B's request, X sells the shares of Y credited to B's account (315 shares) for $10 per share and distributes the proceeds ($3,150) to B together with the remaining balance of $26.50 in B's account. The receipt of the $26.50 does not result in any tax consequences to B. B recognizes a long-term capital gain of $100 and a short- term capital gain of $50, computed as follows:

(1) B is treated as owning 110 shares of Y as of October 1, 1969. The basis of these shares is $1,000, and they were sold for $1,100 (110 shares at $10 per share). Therefore, B recognizes a gain from the sale or exchange of a capital asset held for more than 6 months in the amount of $100.

(2) B is treated as owning 105 shares of Y as of January 1, 1970, and 100 shares as of April 1, 1970. With respect to the shares acquired on April 1, 1970, there is no gain recognized as the shares were sold for $1,000, which is B's basis of the shares. The shares acquired on January 1, 1970, were sold for $1,050 (105 shares at $10 per share), and B's basis of these shares is $1,000. Therefore, B recognizes a gain of $50 from the sale or exchange of a capital asset held for not more than 6 months.

(b) On April 4, 1970, at B's request, X distributes to B the shares of Y credited to his account and $26.50 in cash. The receipt of the $26.50 does not result in any tax consequences to B. B does not recognize gain or loss on the distribution of the shares of Y to him. The bases and holding periods of B's interests in Y are as follows:

Number of shares	Date acquired	Basis
110	10–1–69	$9.09
105	1–1–70	9.52
100	4–1–70	10.00

(d) *Definition*. A unit investment trust to which this section refers is a business arrangement (other than a segregated asset account, whether or not it holds assets pursuant to a variable annuity contract, under the insurance laws or regulations of a State) which (except for taxable years ending before Jan. 1, 1969)—

(1) Is a unit investment trust (as defined in the Investment Company Act of 1940);

(2) Is registered under such Act;

(3) Issues periodic payment plan certificates (as defined in such Act) in one or more series;

(4) Possesses, as substantially all of its assets, as to all such series, securities issued by—

(i) A single management company (as defined in such Act), and securities acquired pursuant to subparagraph (5) of this paragraph, or

(ii) A single other corporation; and

(5) Has no power to invest in any other securities except securities issued by a single other management company, when permitted by such Act or the rules and regulations of the Securities and Exchange Commission.

(e) *Investment in two single management companies*. (1) A unit investment trust may possess securities issued by two or more separate single management companies (as defined in such Act) if—

(i) The trust issues a separate series of periodic payment plan certificates (as defined in such Act) with respect to the securities of each separate single management company which it possesses; and

(ii) None of the periodic payment plan certificates issued by the trust permits joint acquisition of an interest in each series nor the application of payments in whole or in part first to a series issued by one of the single management companies and then to any other series issued by any other single management company.

(2) If a unit investment trust possesses securities of two or more separate single management companies as described in subparagraph (1) of this paragraph and issues a separate series of periodic payment plan certificates with respect to the securities of each such management company, then the holder of an interest in a series shall be treated as the owner of the securities

in the single management company represented by such interest.

(i) A holder of an interest in a series of periodic payment plan certificates of a trust who transfers or sells his interest in the series in exchange for an interest in another series of periodic payment plan certificates of the trust shall recognize the gain or loss realized from the transfer or sale as if the trust had sold the shares credited to his interests in the series at fair market value and distributed the proceeds of the sale to him.

(ii) The basis of the interests in the series so acquired by the holder shall be the fair market value of his interests in the series transferred or sold.

(iii) The period for which the holder has held his interest in the series so acquired shall be measured from the date of his acquisition of his interest in that series.

(f) *Cross references.* (1) For reporting requirements imposed on custodians of unit investment trusts described in this section, see §§ 1.852–4, 1.852–9, 1.853–3, 1.854–2, and 1.6042–2.

(2) For rules relating to redemptions of certain unit investment trusts not described in this section, see § 1.852–10.

[T.D. 7187, 37 FR 13254, July 6, 1972, as amended by T.D. 7187, 37 FR 20688, Oct. 3, 1972]

§ 1.852–1 Taxation of regulated investment companies.

(a) *Requirements applicable thereto*—(1) *In general.* Section 852(a) denies the application of the provisions of part I, subchapter M, chapter 1 of the Code (other than section 852(c), relating to earnings and profits), to a regulated investment company for a taxable year beginning after February 28, 1958, unless—

(i) The deduction for dividends paid for such taxable year as defined in section 561 (computed without regard to capital gain dividends) is equal to at least 90 percent of its investment company taxable income for such taxable year (determined without regard to the provisions of section 852(b)(2)(D) and paragraph (d) of § 1.852–3); and

(ii) The company complies for such taxable year with the provisions of § 1.852–6 (relating to records required to be maintained by a regulated investment company).

See section 853(b)(1)(B) and paragraph (a) of § 1.853–2 for amounts to be added to the dividends paid deduction, and section 855 and § 1.855–1, relating to dividends paid after the close of the taxable year.

(2) *Special rule for taxable years of regulated investment companies beginning before March 1, 1958.* The provisions of part I of subchapter M (including section 852(c)) are not applicable to a regulated investment company for a taxable year beginning before March 1, 1958, unless such company meets the requirements of section 852(a) and subparagraph (1) (i) and (ii) of this paragraph.

(b) *Failure to qualify.* If a regulated investment company does not meet the requirements of section 852(a) and paragraph (a)(1) (i) and (ii) of this section for the taxable year, it will, even though it may otherwise be classified as a regulated investment company, be taxed in such year as an ordinary corporation and not as a regulated investment company. In such case, none of the provisions of part I of subchapter M (other than section 852(c) in the case of taxable years beginning after February 28, 1958) will be applicable to it. For the rules relating to the applicability of section 852(c), see § 1.852–5.

[T.D. 6598, 27 FR 4091, Apr. 28, 1962]

§ 1.852–2 Method of taxation of regulated investment companies.

(a) *Imposition of normal tax and surtax.* Section 852(b)(1) imposes a normal tax and surtax, computed at the rates and in the manner prescribed in section 11, on the investment company taxable income, as defined in section 852(b)(2) and § 1.852–3, for each taxable year of a regulated investment company. The tax is imposed as if the investment company taxable income were the taxable income referred to in section 11. In computing the normal tax under section 11, the regulated investment company's taxable income and the dividends paid deduction (computed without regard to the capital gains dividends) shall both be reduced by the deduction for partially tax-exempt interest provided by section 242.

(b) *Taxation of capital gains*—(1) *In general.* Section 852(b)(3)(A) imposes (i) in the case of a taxable year beginning

before January 1, 1970, a tax of 25 percent, or (ii) in the case of a taxable year beginning after December 31, 1969, a tax determined as provided in section 1201(a) and paragraph (a)(3) of § 1.1201–1, on the excess, if any, of the net long-term capital gain of a regulated investment company (subject to tax under part I, subchapter M, chapter 1 of the Code) over the sum of its net short-term capital loss and its deduction for dividends paid (as defined in section 561) determined with reference to capital gain dividends only. For the definition of capital gain dividend paid by a regulated investment company, see section 852(b)(3)(C) and paragraph (c) of § 1.852–4. In the case of a taxable year ending after December 31, 1969, and beginning before January 1, 1975, such deduction for dividends paid shall first be made from the amount subject to tax in accordance with section 1201(a)(1)(B), to the extent thereof, and then from the amount subject to tax in accordance with section 1201(a)(1)(A). See § 1.852–10, relating to certain distributions in redemption of interests in unit investment trusts which, for purposes of the deduction for dividends paid with reference to capital gain dividends only, are not considered preferential dividends under section 562(c). See section 855 and § 1.855–1, relating to dividends paid after the close of the taxable year.

(2) *Undistributed capital gains*—(i) *In general*. A regulated investment company (subject to tax under part I of subchapter M) may, for taxable years beginning after December 31, 1956, designate under section 852(b)(3)(D) an amount of undistributed capital gains to each shareholder of the company. For the definition of the term ''undistributed capital gains'' and for the treatment of such amounts by a shareholder, see paragraph (b)(2) of § 1.852–4. For the rules relating to the method of making such designation, the returns to be filed, and the payment of the tax in such cases, see paragraph (a) of § 1.852–9.

(ii) *Effect on earnings and profits of a regulated investment company*. If a regulated investment company designates an amount as undistributed capital gains for a taxable year, the earnings and profits of such regulated investment company for such taxable year shall be reduced by the total amount of the undistributed capital gains so designated. In such case, its capital account shall be increased—

(*a*) In the case of a taxable year ending before January 1, 1970, by 75 percent of the total amount designated,

(*b*) In the case of a taxable year ending after December 31, 1969, and beginning before January 1, 1975, by the total amount designated decreased by the amount of tax imposed by section 852(b)(3)(A) with respect to such amount, or

(*c*) In the case of a taxable year beginning after December 31, 1974, by 70 percent of the total amount designated. The earnings and profits of a regulated investment company shall not be reduced by the amount of tax which is imposed by section 852(b)(3)(A) on an amount designated as undistributed capital gains and which is paid by the corporation but deemed paid by the shareholder.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 6598, 27 FR 4091, Apr. 28, 1962; T.D. 6921, 32 FR 8754, June 20, 1967; T.D. 7337, 39 FR 44972, Dec. 30, 1974]

§ 1.852–3 Investment company taxable income.

Section 852(b)(2) requires certain adjustments to be made to convert taxable income of the investment company to investment company taxable income, as follows:

(a) The excess, if any, of the net long-term capital gain over the net short-term capital loss shall be excluded;

(b) The net operating loss deduction provided in section 172 shall not be allowed;

(c) The special deductions provided in part VIII (section 241 and following, except section 248), subchapter B, chapter 1 of the Code, shall not be allowed. Those not allowed are the deduction for partially tax-exempt interest provided by section 242, the deductions for dividends received provided by sections 243, 244, and 245, and the deduction for certain dividends paid provided by section 247. However, the deduction provided by section 248 (relating to organizational expenditures), otherwise allowable in computing taxable income, shall likewise be allowed in computing

the investment company taxable income. See section 852(b)(1) and paragraph (a) of § 1.852–2 for treatment of the deduction for partially tax-exempt interest (provided by section 242) for purposes of computing the normal tax under section 11;

(d) The deduction for dividends paid (as defined in section 561) shall be allowed, but shall be computed without regard to capital gains dividends (as defined in section 852(b)(3)(C) and paragraph (c) of § 1.852–4); and

(e) The taxable income shall be computed without regard to section 443(b). Thus, the taxable income for a period of less than 12 months shall not be placed on an annual basis even though such short taxable year results from a change of accounting period.

§ 1.852–4 Method of taxation of shareholders of regulated investment companies.

(a) *Ordinary income.* (1) Except as otherwise provided in paragraph (b) of this section (relating to capital gains), a shareholder receiving dividends from a regulated investment company shall include such dividends in gross income for the taxable year in which they are received.

(2) See section 853 (b)(2) and (c) and paragraph (b) of § 1.853–2 and § 1.853–3 for the treatment by shareholders of dividends received from a regulated investment company which has made an election under section 853(a) with respect to the foreign tax credit. See section 854 and §§ 1.854–1 through 1.854–3 for limitations applicable to dividends received from regulated investment companies for the purpose of the credit under section 34 (for dividends received on or before December 31, 1964), the exclusion from gross income under section 116, and the deduction under section 243. See section 855 (b) and (d) and paragraphs (c) and (f) of § 1.855–1 for treatment by shareholders of dividends paid by a regulated investment company after the close of the taxable year in the case of an election under section 855(a).

(b) *Capital gains*—(1) *In general.* Under section 852(b)(3)(B), shareholders of a regulated investment company who receive capital gain dividends (as defined in paragraph (c) of this section), in respect of the capital gains of an investment company for a taxable year for which it is taxable under part I, subchapter M, chapter 1 of the Code, as a regulated investment company, shall treat such capital gain dividends as gains from the sale or exchange of capital assets held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) and realized in the taxable year of the shareholder in which the dividend was received. In the case of dividends with respect to any taxable year of a regulated investment company ending after December 31, 1969, and beginning before January 1, 1975, the portion of a shareholder's capital gain dividend to which section 1201(d) (1) or (2) applies is the portion so designated by the regulated investment company pursuant to paragraph (c)(2) of this section.

(2) *Undistributed capital gains.* (i) A person who is a shareholder of a regulated investment company at the close of a taxable year of such company for which it is taxable under part I of subchapter M shall include in his gross income as a gain from the sale or exchange of a capital asset held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) any amount of undistributed capital gains. The term ''undistributed capital gains'' means the amount designated as undistributed capital gains in accordance with paragraph (a) of § 1.852–9, but the amount so designated shall not exceed the shareholder's proportionate part of the amount subject to tax under section 852(b)(3)(A). Such amount shall be included in gross income for the taxable year of the shareholder in which falls the last day of the taxable year of the regulated investment company in respect of which the undistributed capital gains were designated. The amount of such gains designated under paragraph (a) of § 1.852–9 as gain described in section 1201(d) (1) or (2) shall be included in the shareholder's gross income as gain described in section 1201(d) (1) or (2). For certain administrative provisions relating to undistributed capital gains, see § 1.852–9.

(ii) Any shareholder required to include an amount of undistributed capital gains in gross income under section 852(b)(3)(D)(i) and subdivision (i) of this subparagraph shall be deemed to have paid for his taxable year for which such amount is so includible—

(*a*) In the case of an amount designated with respect to a taxable year of the company ending before January 1, 1970, a tax equal to 25 percent of such amount.

(*b*) In the case of a taxable year of the company ending after December 31, 1969, and beginning before January 1, 1975, a tax equal to the tax designated under paragraph (a)(1) of §1.852–9 by the regulated investment company as his proportionate share of the capital gains tax paid with respect to such amount, or

(*c*) In the case of an amount designated with respect to a taxable year of the company beginning after December 31, 1974, a tax equal to 30 percent of such amount.

Such shareholder is entitled to a credit or refund of the tax so deemed paid in accordance with the rules provided in paragraph (c)(2) of §1.852–9.

(iii) Any shareholder required to include an amount of undistributed capital gains in gross income under section 852(b)(3)(D)(i) and subdivision (i) of this subparagraph shall increase the adjusted basis of the shares of stock with respect to which such amount is so includible—

(*a*) In the case of an amount designated with respect to a taxable year of the company ending before January 1, 1970, by 75 percent of such amount.

(*b*) In the case of an amount designated with respect to a taxable year of the company ending after December 31, 1969, and beginning before January 1, 1975, by the amount designated under paragraph (a)(1)(iv) of §1.852–9 by the regulated investment company, or

(*c*) In the case of an amount designated with respect to a taxable year of the company beginning after December 31, 1974, by 70 percent of such amount.

(iv) For purposes of determining whether the purchaser or seller of a share or regulated investment company stock is the shareholder at the close of such company's taxable year who is required to include an amount of undistributed capital gains in gross income, the amount of the undistributed capital gains shall be treated in the same manner as a cash dividend payable to shareholders of record at the close of the company's taxable year. Thus, if a cash dividend paid to shareholders of record as of the close of the regulated investment company's taxable year would be considered income to the purchaser, then the purchaser is also considered to be the shareholder of such company at the close of its taxable year for purposes of including an amount of undistributed capital gains in gross income. If, in such a case, notice on Form 2439 is, pursuant to paragraph (a)(1) of §1.852–9, mailed by the regulated investment company to the seller, then the seller shall be considered the nominee of the purchaser and, as such, shall be subject to the provisions in paragraph (b) of §1.852–9. For rules for determining whether a dividend is income to the purchaser or seller of a share of stock, see paragraph (c) of §1.61–9.

(3) *Partners and partnerships.* If the shareholder required to include an amount of undistributed capital gains in gross income under section 852(b)(3)(D) and subparagraph (2) of this paragraph is a partnership, such amount shall be included in the gross income of the partnership for the taxable year of the partnership in which falls the last day of the taxable year of the regulated investment company in respect of which the undistributed capital gains were designated. The amount so includible by the partnership shall be taken into account by the partners as distributive shares of the partnership gains and losses from sales or exchanges of capital assets held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) pursuant to section 702(a)(2) and paragraph (a)(2) of §1.702–1. The tax with respect to the undistributed capital gains is deemed paid by the partnership (under section 852(b)(3)(D)(ii) and subparagraph (2)(ii) of this paragraph), and the credit or refund of such tax shall be taken into account by the partners in accordance with section 702(a)(8) and paragraph (a)(8)(ii) of §1.702–1 and paragraph (c)(2)

of § 1.852–9. In accordance with section 705(a), the partners shall increase the basis of their partnership interests under section 705(a)(1) by the distributive shares of such gains, and shall decrease the basis of their partnership interests by the distributive shares of the amount of the tax under section 705(a)(2)(B) (relating to certain nondeductible expenditures) and paragraph (a)(3) of § 1.705–1.

(4) *Nonresident alien individuals.* If the shareholder required to include an amount of undistributed capital gains in gross income under section 852(b)(3)(D) and subparagraph (2) of this paragraph is a nonresident alien individual, such shareholder shall be treated, for purposes of section 871 and the regulations thereunder, as having realized a long-term capital gain in such amount on the last day of the taxable year of the regulated investment company in respect of which the undistributed capital gains were designated.

(5) *Effect on earnings and profits of corporate shareholders of a regulated investment company.* If a shareholder required to include an amount of undistributed capital gains in gross income under section 852(b)(3)(D) and subparagraph (2) of this paragraph is a corporation, such corporation, in computing its earnings and profits for the taxable year for which such amount is so includible, shall treat such amount as if it had actually been received and the taxes paid shall include any amount of tax liability satisfied by a credit under section 852(b)(3)(D) and subparagraph (2) of this paragraph.

(c) *Definition of capital gain dividend*—(1) *General rule.* A capital gain dividend, as defined in section 852(b)(3)(C), is any dividend or part thereof which is designated by a regulated investment company as a capital gain dividend in a written notice mailed to its shareholders within the period specified in paragraph (c)(4) of this section. If the aggregate amount so designated with respect to the taxable year (including capital gain dividends paid after the close of the taxable year pursuant to an election under section 855) is greater than the excess of the net long-term capital gain over the net short-term capital loss of the taxable year, the portion of each distribution which shall be a capital gain dividend shall be only that proportion of the amount so designated which such excess of the net long-term capital gain over the net short-term capital loss bears to the aggregate amount so designated. For example, a regulated investment company making its return on the calendar year basis advised its shareholders by written notice mailed December 30, 1955, that of a distribution of $500,000 made December 15, 1955, $200,000 constituted a capital gain dividend, amounting to $2 per share. It was later discovered that an error had been made in determining the excess of the net long-term capital gain over the net short-term capital loss of the taxable year, and that such excess was $100,000 instead of $200,000. In such case each shareholder would have received a capital gain dividend of $1 per share instead of $2 per share.

(2) *Shareholder of record custodian of certain unit investment trusts.* In any case where a notice is mailed pursuant to subparagraph (1) of this paragraph by a regulated investment company with respect to a taxable year of the regulated investment company ending after December 8, 1970, to a shareholder of record who is a nominee acting as a custodian of a unit investment trust described in section 851(f)(1) and paragraph (d) of § 1.851–7, the nominee shall furnish each holder of an interest in such trust with a written notice mailed on or before the 55th day following the close of the regulated investment company's taxable year. The notice shall designate the holder's proportionate share of the capital gain dividend shown on the notice received by the nominee pursuant to subparagraph (1) of this paragraph. The notice shall include the name and address of the nominee identified as such. This subparagraph shall not apply if the regulated investment company agrees with the nominee to satisfy the notice requirements of subparagraph (1) of this paragraph with respect to each holder of an interest in the unit investment trust whose shares are being held by the nominee as custodian and, not later than 45 days following the close of the company's taxable year, files with the Internal Revenue Service office where the company's income tax

return is to be filed for the taxable year, a statement that the holders of the unit investment trust with whom the agreement was made have been directly notified by the regulated investment company. Such statement shall include the name, sponsor, and custodian of each unit investment trust whose holders have been directly notified. The nominee's requirements under this paragraph shall be deemed met if the regulated investment company transmits a copy of such statement to the nominee within such 45-day period; provided however, if the regulated investment company fails or is unable to satisfy the requirements of this subparagraph with respect to the holders of interest in the unit investment trust, it shall so notify the Internal Revenue Service within 45 days following the close of its taxable year. The custodian shall, upon notice by the Internal Revenue Service that the regulated investment company has failed to comply with the agreement, satisfy the requirements of this subparagraph within 30 days of such notice. If a notice under paragraph (c)(1) of this section is mailed within the 120-day period following the date of a determination pursuant to paragraph (c)(4)(ii) of this section, the 120-day period and the 130-day period following the date of the determination shall be substituted for the 45-day period and the 55-day period following the close of the regulated investment company's taxable year prescribed by this subparagraph (2).

(3) *Subsection (d) gain for certain taxable years.* In the case of capital gain dividends with respect to any taxable year of a regulated investment company ending after December 31, 1969, and beginning before January 1, 1975 (including capital gain dividends paid after the close of the taxable year pursuant to an election under section 855), the company must include in its written notice under paragraph (c)(1) of this section a statement showing the shareholder's proportionate share of the capital gain dividend which is gain described in section 1201(d)(1) and his proportionate share of such dividend which is gain described in section 1201(d)(2). In determining the portion of the capital gain dividend which, in the hands of a shareholder, is gain described in section 1201(d) (1) or (2), the regulated investment company shall consider that capital gain dividends for a taxable year are first made from its long-term capital gains for such year which are not described in section 1201(d) (1) or (2), to the extent thereof, and then from its long-term capital gains for such year which are described in section 1201(d) (1) or (2). A shareholder's proportionate share of gains which are described in section 1201(d)(1) is the amount which bears the same ratio to the amount paid to him as a capital gain dividend in respect of such year as (i) the aggregate amount of the company's gains which are described in section 1201(d)(1) and paid to all shareholders bears to (ii) the aggregate amount of the capital gain dividend paid to all shareholders in respect of such year. A shareholder's proportionate share of gains which are described in section 1201(d)(2) shall be determined in a similar manner. Every regulated investment company shall keep a record of the proportion of each capital gain dividend (to which this paragraph applies) which is gain described in section 1201(d) (1) or (2). If, for his taxable year, a shareholder must include in his gross income a capital gain dividend to which this paragraph applies, he shall attach to his income tax return for such taxable year a statement showing, with respect to the total of such dividends for such taxable year received from each regulated investment company, the name and address of the regulated investment company from which such dividends are received, the amount of such dividends, the portion of such dividends which was designated as gain described in section 1201(d)(1), and the portion of such dividends which was designated as gain described in section 1201(d)(2).

(4) *Mailing of written notice to shareholders.* (i) Except as provided in paragraph (c)(4)(ii) of this section, the written notice designating a dividend or part thereof as a capital gain dividend must be mailed to the shareholders not later than 45 days (30 days for a taxable year ending before February 26, 1964) after the close of the taxable year of the regulated investment company.

(ii) If a determination (as defined in section 860(e)) after November 6, 1978,

increases the excess for the taxable year of the net capital gain over the deduction for capital gains dividends paid, then a regulated investment company may designate all or part of any dividend as a capital gain dividend in a written notice mailed to its shareholders at any time during the 120-day period immediately following the date of the determination. The aggregate amount designated during this period may not exceed this increase. A dividend may be designated if it is actually paid during the taxable year, is one paid after the close of the taxable year to which section 855 applies, or is a deficiency dividend (as defined in section 860(f)), including a deficiency dividend paid by an acquiring corporation to which section 381(c)(25) applies. The date of a determination is established under § 1.860–2(b)(1).

(d) *Special treatment of loss on the sale or exchange of regulated investment company stock held less than 31 days*—(1) *In general*. Under section 852(b)(4), if any person, with respect to a share of regulated investment company stock acquired by such person after December 31, 1957, and held for a period of less than 31 days, is required by section 852(b)(3) (B) or (D) to include in gross income as a gain from the sale or exchange of a capital asset held for more than six months—

(i) The amount of a capital gain dividend, or

(ii) An amount of undistributed capital gains,

then such person shall, to the extent of such amount, treat any loss on the sale or exchange of such share of stock as a loss from the sale or exchange of a capital asset held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977). Such special treatment with respect to the sale of regulated investment company stock held for a period of less than 31 days is applicable to losses for taxable years ending after December 31, 1957.

(2) *Determination of holding period*. The rules contained in section 246(c)(3) (relating to the determination of holding periods for purposes of the deduction for dividends received) shall be applied in determining whether, for purposes of section 852(b)(4) and this paragraph, a share of regulated investment company stock has been held for a period of less than 31 days. In applying those rules, however, ''30 days'' shall be substituted for the number of days specified in subparagraph (B) of section 246(c)(3).

(3) *Example*. The application of section 852(b)(4) and this paragraph may be illustrated by the following example:

Example. On December 15, 1958, A purchased a share of stock in the X regulated investment company for $20. The X regulated investment company declared a capital gain dividend of $2 per share to shareholders of record on December 31, 1958. A, therefore, received a capital gain dividend of $2 which, pursuant to section 852(b)(3)(B), he must treat as a gain from the sale or exchange of a capital asset held for more than 6 months. On January 5, 1959, A sold his share of stock in the X regulated investment company for $17.50, which sale resulted in a loss of $2.50. Under section 852(b)(4) and this paragraph, A must treat $2 of such loss (an amount equal to the capital gain dividend received with respect to such share of stock) as a loss from the sale or exchange of a capital asset held for more than 6 months.

(Sec. 7805, 68A Stat. 917; 26 U.S.C. 7805; 860(e) (92 Stat. 2849, 26 U.S.C. 860(e)); sec. 860(g) (92 Stat. 2850, 26 U.S.C. 860(g)))

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 6531, 26 FR 413, Jan. 19, 1961; T.D. 6598, 27 FR 4091, Apr. 28, 1962; T.D. 6777, 29 FR 17809, Dec. 16, 1964; T.D. 6921, 32 FR 8755, June 20, 1967; T.D. 7187, 37 FR 13256, July 6, 1972; T.D. 7337, 39 FR 44972, Dec. 30, 1974; T.D. 7728, 45 FR 72650, Nov. 3, 1980; T.D. 7936, 49 FR 2106, Jan. 18, 1984]

§ 1.852–5 Earnings and profits of a regulated investment company.

(a) Any regulated investment company, whether or not such company meets the requirements of section 852(a) and paragraphs (a)(1) (i) and (ii) of § 1.852–1, shall apply paragraph (b) of this section in computing its earnings and profits for a taxable year beginning after February 28, 1958. However, for a taxable year of a regulated investment company beginning before March 1, 1958, paragraph (b) of this section shall apply only if the regulated investment company meets the requirements of section 852(a) and paragraphs (a)(1) (i) and (ii) of § 1.852–1.

(b) In the determination of the earnings and profits of a regulated investment company, section 852(c) provides that such earnings and profits for any taxable year (but not the accumulated earnings and profits) shall not be reduced by any amount which is not allowable as a deduction in computing its taxable income for the taxable year. Thus, if a corporation would have had earnings and profits of $500,000 for the taxable year except for the fact that it had a net capital loss of $100,000, which amount was not deductible in determining its taxable income, its earnings and profits for that year if it is a regulated investment company would be $500,000. If the regulated investment company had no accumulated earnings and profits at the beginning of the taxable year, in determining its accumulated earnings and profits as of the beginning of the following taxable year, the earnings and profits for the taxable year to be considered in such computation would amount to $400,000 assuming that there had been no distribution from such earnings and profits. If distributions had been made in the taxable year in the amount of the earnings and profits then available for distribution, $500,000, the corporation would have as of the beginning of the following taxable year neither accumulated earnings and profits nor a deficit in accumulated earnings and profits, and would begin such year with its paid-in capital reduced by $100,000, an amount equal to the excess of the $500,000 distributed over the $400,000 accumulated earnings and profits which would otherwise have been carried into the following taxable year.

§ 1.852–6 Records to be kept for purpose of determining whether a corporation claiming to be a regulated investment company is a personal holding company.

(a) Every regulated investment company shall maintain in the internal revenue district in which it is required to file its income tax return permanent records showing the information relative to the actual owners of its stock contained in the written statements required by this section to be demanded from the shareholders. The actual owner of stock includes the person who is required to include in gross income in his return the dividends received on the stock. Such records shall be kept at all times available for inspection by any internal revenue officer or employee, and shall be retained so long as the contents thereof may become material in the administration of any internal revenue law.

(b) For the purpose of determining whether a domestic corporation claiming to be a regulated investment company is a personal holding company as defined in section 542, the permanent records of the company shall show the maximum number of shares of the corporation (including the number and face value of securities convertible into stock of the corporation) to be considered as actually or constructively owned by each of the actual owners of any of its stock at any time during the last half of the corporation's taxable year, as provided in section 544.

(c) Statements setting forth the information (required by paragraph (b) of this section) shall be demanded not later than 30 days after the close of the corporation's taxable year as follows:

(1) In the case of a corporation having 2,000 or more record owners of its stock on any dividend record date, from each record holder of 5 percent or more of its stock; or

(2) In the case of a corporation having less than 2,000 and more than 200 record owners of its stock, on any dividend record date, from each record holder of 1 percent or more of its stock; or

(3) In the case of a corporation having 200 or less record owners of its stock, on any dividend record date, from each record holder of one-half of 1 percent or more of its stock.

When making demand for the written statements required of each shareholder by this paragraph, the company shall inform each of the shareholders of his duty to submit as a part of his income tax return the statements which are required by § 1.852–7 if he fails or refuses to comply with such demand. A list of the persons failing or refusing to comply in whole or in part with a company's demand shall be maintained as a part of its record required by this section. A company which fails to keep

such records to show the actual ownership of its outstanding stock as are required by this section shall be taxable as an ordinary corporation and not as a regulated investment company.

§ 1.852–7 Additional information required in returns of shareholders.

Any person who fails or refuses to comply with the demand of a regulated investment company for the written statements which § 1.852–6 requires the company to demand from its shareholders shall submit as a part of his income tax return a statement showing, to the best of his knowledge and belief—

(a) The number of shares actually owned by him at any and all times during the period for which the return is filed in any company claiming to be a regulated investment company;

(b) The dates of acquisition of any such stock during such period and the names and addresses of persons from whom it was acquired;

(c) The dates of disposition of any such stock during such period and the names and addresses of the transferees thereof;

(d) The names and addresses of the members of his family (as defined in section 544(a)(2)); the names and addresses of his partners, if any, in any partnership; and the maximum number of shares, if any, actually owned by each in any corporation claiming to be a regulated investment company, at any time during the last half of the taxable year of such company;

(e) The names and addresses of any corporation, partnership, association, or trust in which he had a beneficial interest to the extent of at least 10 percent at any time during the period for which such return is made, and the number of shares of any corporation claiming to be a regulated investment company actually owned by each;

(f) The maximum number of shares (including the number and face value of securities convertible into stock of the corporation) in any domestic corporation claiming to be a regulated investment company to be considered as constructively owned by such individual at any time during the last half of the corporation's taxable year, as provided in section 544 and the regulations thereunder; and

(g) The amount and date of receipt of each dividend received during such period from every corporation claiming to be a regulated investment company.

§ 1.852–8 Information returns.

Nothing in §§ 1.852–6 and 1.852–7 shall be construed to relieve regulated investment companies or their shareholders from the duty of filing information returns required by regulations prescribed under the provisions of subchapter A, chapter 61 of the Code.

§ 1.852–9 Special procedural requirements applicable to designation under section 852(b)(3)(D).

(a) *Regulated investment company*—(1) *Notice to shareholders.* (i) A designation of undistributed capital gains under section 852(b)(3)(D) and paragraph (b)(2)(i) of § 1.852–2 shall be made by notice on Form 2439 mailed by the regulated investment company to each person who is a shareholder of record of the company at the close of the company's taxable year. The notice on Form 2439 shall show the name, address, and employer identification number of the regulated investment company; the taxable year of the company for which the designation is made; the name, address, and identifying number of the shareholder; the amount designated by the company for inclusion by the shareholder in computing his long-term capital gains; and the tax paid with respect thereto by the company which is deemed to have been paid by the shareholder.

(ii) In the case of a designation of undistributed capital gains with respect to a taxable year of the regulated investment company ending after December 31, 1969, and beginning before January 1, 1975, Form 2439 shall also show the shareholder's proportionate share of such gains which is gain described in section 1201(d)(1), his proportionate share of such gains which is gain described in section 1201(d)(2), and the amount (determined pursuant to subdivision (iv) of this subparagraph) by which the shareholder's adjusted basis in his shares shall be increased.

(iii) In determining under subdivision (ii) of this subparagraph the portion of

the undistributed capital gains which, in the hands of the shareholder, is gain described in section 1201(d) (1) or (2), the company shall consider that capital gain dividends for a taxable year are made first from its long-term capital gains for such year which are not described in section 1201(d) (1) or (2), to the extent thereof, and then from its long-term capital gains for such year which are described in section 1201(d) (1) or (2). A shareholder's proportionate share of undistributed capital gains for a taxable year which is gain described in section 1201(d)(1) is the amount which bears the same ratio to the amount included in his income as designated undistributed capital gains for such year as (*a*) the aggregate amount of the company's gains for such year which are described in section 1201(d)(1) and designated as undistributed capital gains bears to (*b*) the aggregate amount of the company's gains for such year which are designated as undistributed capital gains. A shareholder's proportionate share of gains which are described in section 1201(d)(2) shall be determined in a similar manner. Every regulated investment company shall keep a record of the proportion of undistributed capital gains (to which this subdivision applies) which is gain described in section 1201(d) (1) or (2).

(iv) In the case of a designation of undistributed capital gains for any taxable year ending after December 31, 1969, and beginning before January 1, 1975, Form 2439 shall also show with respect to the undistributed capital gains of each shareholder the amount by which such shareholder's adjusted basis in his shares shall be increased under section 852(b)(3)(D)(iii). The amount by which each shareholders' adjusted basis in his shares shall be increased is the amount includible in his gross income with respect to such shares under section 852(b)(3)(D)(i) less the tax which the shareholder is deemed to have paid with respect to such shares. The tax which each shareholder is deemed to have paid with respect to such shares is the amount which bears the same ratio to the amount of the tax imposed by section 852(b)(3)(A) for such year with respect to the aggregate amount of the designated undistributed capital gains as the amount of such gains includible in the shareholder's gross income bears to the aggregate amount of such gains so designated.

(v) Form 2439 shall be prepared in triplicate, and copies B and C of the form shall be mailed to the shareholder on or before the 45th day (30th day for a taxable year ending before February 26, 1964) following the close of the company's taxable year. Copy A of each Form 2439 must be associated with the duplicate copy of the undistributed capital gains tax return of the company (Form 2438), as provided in subparagraph (2)(ii) of this paragraph.

(2) *Return of undistributed capital gains tax*—(i) *Form 2438*. Every regulated investment company which designates undistributed capital gains for any taxable year beginning after December 31, 1956, in accordance with subparagraph (1) of this paragraph, shall file for such taxable year an undistributed capital gains tax return on Form 2438 including on such return the total of its undistributed capital gains so designated and the tax with respect thereto. The return on Form 2438 shall be prepared in duplicate and shall set forth fully and clearly the information required to be included therein. The original of Form 2438 shall be filed on or before the 30th day after the close of the company's taxable year with the internal revenue officer designated in instructions applicable to Form 2438. The duplicate copy of form 2438 for the taxable year shall be attached to and filed with the income tax return of the company on Form 1120 for such taxable year.

(ii) *Copies A of Form 2439*. For each taxable year which ends on or before December 31, 1965, there shall be submitted with the company's return on Form 2438 all copies A of Form 2439 furnished by the company to its shareholders in accordance with subparagraph (1) of this paragraph. For each taxable year which ends after December 31, 1965, there shall be submitted with the duplicate copy of the company's return on Form 2438, which is attached to and filed with the income tax return of the company on Form 1120 for the taxable year, all copies A of Form 2439 furnished by the company to its shareholders in accordance with

subparagraph (1) of this paragraph. The copies A of Form 2439 shall be accompanied by lists (preferably in the form of adding machine tapes) of the amounts of undistributed capital gains and of the tax paid with respect thereto shown on such forms. The totals of the listed amounts of undistributed capital gains and of tax paid with respect thereto must agree with the corresponding entries on Form 2438.

(3) *Payment of tax*. The tax required to be returned on Form 2438 shall be paid by the regulated investment company on or before the 30th day after the close of the company's taxable year to the internal revenue officer with whom the return on Form 2438 is filed.

(b) *Shareholder of record not actual owner*—(1) *Notice to actual owner*. In any case in which a notice on Form 2439 is mailed pursuant to paragraph (a)(1) of this section by a regulated investment company to a shareholder of record who is a nominee of the actual owner or owners of the shares of stock to which the notice relates, the nominee shall furnish to each such actual owner notice of the owner's proportionate share of the amounts of undistributed capital gains and tax with respect thereto, as shown on the Form 2439 received by the nominee from the regulated investment company. The nominee's notice to the actual owner shall be prepared in triplicate on Form 2439 and shall contain the information prescribed in paragraph (a)(1) of this section, except that the name and address of the nominee, identified as such, shall be entered on the form in addition to, and in the space provided for, the name and address of the regulated investment company, and the amounts of undistributed capital gains and tax with respect thereto entered on the form shall be the actual owner's proportionate share of the corresponding items shown on the nominee's notice from the regulated investment company. Copies B and C of the Form 2439 prepared by the nominee shall be mailed to the actual owner—

(i) For taxable years of regulated investment companies ending after February 25, 1964, on or before the 75th day (55th day in the case of a nominee who is acting as a custodian of a unit investment trust described in section 851(f)(1) and paragraph (d) of §1.851–7 for taxable years of regulated investment companies ending after December 8, 1970, and 135th day if the nominee is a resident of a foreign country) following the close of the regulated investment company's taxable year, or

(ii) For taxable years of regulated investment companies ending before February 26, 1964, on or before the 60th day (120th day if the nominee is a resident of a foreign country) following the close of the regulated investment company's taxable year.

(2) *Transmittal of Form 2439*. The nominee shall enter the word ''Nominee'' in the upper right hand corner of copy B of the notice on Form 2439 received by him from the regulated investment company, and on or before the appropriate day specified in subdivision (i) or (ii) of subparagraph (1) of this paragraph shall transmit such copy B, together with all copies A of Form 2439 prepared by him pursuant to subparagraph (1) of this paragraph, to the internal revenue officer with whom his income tax return is required to be filed.

(3) *Custodian of certain unit investment trusts*. The requirements of this paragraph shall not apply to a nominee who is acting as a custodian of the unit investment trust described in section 851(f)(1) and paragraph (d) of §1.851–7 provided that the regulated investment company agrees with the nominee to satisfy the notice requirements of paragraph (a) of this section with respect to each holder of an interest in the unit investment trust whose shares are being held by such nominee as custodian and on or before the 45th day following the close of the company's taxable year, files with the Internal Revenue Service office where the company's income tax return is to be filed for the taxable year, a statement that the holders of the unit investment trust with whom the agreement was made have been directly notified by the regulated investment company. Such statement shall include the name, sponsor, and custodian of each unit investment trust whose holders have been directly notified. The nominee's requirements under this paragraph shall be deemed met if the regulated investment company transmits a

copy of such statement to the nominee within such 45-day period; provided however, if the regulated investment company fails or is unable to satisfy the requirements of this paragraph with respect to the holders of interest in the unit investment trust, it shall so notify the Internal Revenue Service within 45 days following the close of its taxable year. The custodian shall, upon notice by the Internal Revenue Service that the regulated investment company has failed to comply with the agreement, satisfy the requirements of this paragraph within 30 days of such notice.

(c) *Shareholders*—(1) *Return and Recordkeeping Requirements*—(i) *Return requirements for taxable years beginning before January 1, 2002.* For taxable years beginning before January 1, 2002, the copy B of Form 2439 furnished to a shareholder by the regulated investment company or by a nominee, as provided in §1.852–9(a) or (b) shall be attached to the income tax return of the shareholder for the taxable year in which the amount of undistributed capital gains is includible in gross income as provided in §1.852–4(b)(2).

(ii) *Recordkeeping requirements for taxable years beginning after December 31, 2001.* For taxable years beginning after December 31, 2001, the shareholder shall retain a copy of Form 2439 for as long as its contents may become material in the administration of any internal revenue law.

(2) *Credit or refund*—(i) *In general.* The amount of the tax paid by the regulated investment company with respect to the undistributed capital gains required under section 852(b)(3)(D) and paragraph (b)(2) of §1.852–4 to be included by a shareholder in his computation of long-term capital gains for any taxable year is deemed paid by such shareholder under section 852(b)(3)(D)(ii) and such payment constitutes, for purposes of section 6513(a) (relating to time tax considered paid), an advance payment in like amount of the tax imposed under chapter 1 of the Code for such taxable year. In the case of an overpayment of tax within the meaning of section 6401, see section 6402 and the regulations in part 301 of this chapter (Regulations on Procedure and Administration) for rules applicable to the treatment of an overpayment of tax and section 6511 and the regulations in part 301 of this chapter (Regulations on Procedure and Administration) with respect to the limitations applicable to the credit or refund of an overpayment of tax.

(ii) *Form to be used.* Claim for refund or credit of the tax deemed to have been paid by a shareholder with respect to an amount of undistributed capital gains shall be made on the shareholder's income tax return for the taxable year in which such amount of undistributed capital gains is includable in gross income. In the case of a shareholder which is a partnership, claim shall be made by the partners on their income tax returns for refund or credit of their distributive shares of the tax deemed to have been paid by the partnership. In the case of a shareholder which is exempt from tax under section 501(a) and to which section 511 does not apply for the taxable year, claim for refund of the tax deemed to have been paid by such shareholder on an amount of undistributed capital gains for such year shall be made on Form 843 and copy B of Form 2439 furnished to such shareholder shall be attached to its claim. For other rules applicable to the filing of claims for credit or refund of an overpayment of tax, see §301.6402–2 of this chapter (Regulations on Procedure and Administration), relating to claims for credit or refund, and §301.6402–3 of this chapter, relating to special rules applicable to income tax.

(3) *Records.* The shareholder is required to keep copy C of the Form 2439 furnished for the regulated investment company's taxable years ending after December 31, 1969, and beginning before January 1, 1975, as part of his records to show increases in the adjusted basis of his shares in such company.

(d) *Penalties.* For criminal penalties for willful failure to file a return, supply information, or pay tax, and for filing a false or fraudulent return, statement, or other document, see sections 7203, 7206, and 7207.

[T.D. 6500, 25 FR 11710, Nov. 26, 1960, as amended by T.D. 6921, 32 FR 8755, June 20, 1967; T.D. 7012, 34 FR 7688, May 15, 1969; T.D. 7187, 37 FR 13256, July 6, 1972; T.D. 7332, 39 FR 44217, Dec. 23, 1974; T.D. 7337, 39 FR 44973, Dec. 30, 1974; T.D. 8989, 67 FR 20031, Apr. 24, 2002; T.D. 9040, 68 FR 4921, Jan. 31, 2003]

§ 1.852–10 Distributions in redemption of interests in unit investment trusts.

(a) *In general.* In computing that part of the excess of its net long-term capital gain over net short-term capital loss on which it must pay a capital gains tax, a regulated investment company is allowed under section 852(b)(3)(A)(ii) a deduction for dividends paid (as defined in section 561) determined with reference to capital gains dividends only. Section 561(b) provides that in determining the deduction for dividends paid, the rules provided in section 562 are applicable. Section 562(c) (relating to preferential dividends) provides that the amount of any distribution shall not be considered as a dividend unless such distribution is pro-rata, with no preference to any share of stock as compared with other shares of the same class except to the extent that the former is entitled to such preference.

(b) *Redemption distributions made by unit investment trust*—(1) *In general.* Where a unit investment trust (as defined in paragraph (c) of this section) liquidates part of its portfolio represented by shares in a management company in order to make a distribution to a holder of an interest in the trust in redemption of part or all of such interest, and by so doing, the trust realizes net long-term capital gain, that portion of the distribution by the trust which is equal to the amount of the net long-term capital gain realized by the trust on the liquidation of the shares in the management company will not be considered a preferential dividend under section 562(c). For example, where the entire amount of net long-term capital gain realized by the trust on such a liquidation is distributed to the redeeming interest holder, the trust will be allowed the entire amount of net long-term capital gain so realized in determining the deduction under section 852(b)(3)(A)(ii) for dividends paid determined with reference to capital gains dividends only. This paragraph and section 852(d) shall apply only with respect to the capital gain net income (net capital gain for taxable years beginning before January 1, 1977) realized by the trust which is attributable to a redemption by a holder of an interest in such trust. Such dividend may be designated as a capital gain dividend by a written notice to the certificate holder. Such designation should clearly indicate to the holder that the holder's gain or loss on the redemption of the certificate may differ from such designated amount, depending upon the holder's basis for the redeemed certificate, and that the holder's own records are to be used in computing the holder's gain or loss on the redemption of the certificate.

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

Example. B entered into a periodic payment plan contract with X as custodian and Z as plan sponsor under which he purchased a plan certificate of X. Under this contract, upon B's demand, X must redeem B's certificate at a price substantially equal to the value of the number of shares in Y, a management company, which are credited to B's account by X in connection with the unit investment trust. Except for a small amount of cash which X is holding to satisfy liabilities and to invest for other plan certificate holders, all of the assets held by X in connection with the trust consist of shares in Y. Pursuant to the terms of the periodic payment plan contract, 100 shares of Y are credited to B's account. Both X and Y have elected to be treated as regulated investment companies. On March 1, 1965, B notified X that he wished to have his entire interest in the unit investment trust redeemed. In order to redeem B's interest, X caused Y to redeem 100 shares of Y which X held. At the time of redemption, each share of Y had a value of $15. X then distributed the $1,500 to B. X's basis for each of the Y shares which was redeemed was $10. Therefore, X realized a long-term capital gain of $500 ($5 × 100 shares) which is attributable to the redemption by B of his interest in the trust. Under section 852(d), the $500 capital gain distributed to B will not be considered a preferential dividend. Therefore, X

is allowed a deduction of $500 under section 852(b)(3)(A)(ii) for dividends paid determined with reference to capital gains dividends only, with the result that X will not pay a capital gains tax with respect to such amount.

(c) *Definition of unit investment trust.* A unit investment trust to which paragraph (a) of this section refers is a business arrangement which—

(1) Is registered under the Investment Company Act of 1940 as a unit investment trust;

(2) Issues periodic payment plan certificates (as defined in such Act);

(3) Possesses, as substantially all of its assets, securities issued by a management company (as defined in such Act);

(4) Qualifies as a regulated investment company under section 851; and

(5) Complies with the requirements provided for by section 852(a).

Paragraph (a) of this section does not apply to a unit investment trust described in section 851(f)(1) and paragraph (d) of § 1.851–7.

[T.D. 6921, 32 FR 8755, June 20, 1967, as amended by T.D. 7187, 37 FR 13527, July 6, 1972; T.D. 7728, 45 FR 72650, Nov. 3, 1980]

§ 1.852–11 Treatment of certain losses attributable to periods after October 31 of a taxable year.

(a) *Outline of provisions.* This paragraph lists the provisions of this section.

(a) Outline of provisions.
(b) Scope.
(1) In general.
(2) Limitation on application of section.
(c) Post-October capital loss defined.
(1) In general.
(2) Methodology.
(3) October 31 treated as last day of taxable year for purpose of determining taxable income under certain circumstances.
(i) In general.
(ii) Effect on gross income.
(d) Post-October currency loss defined.
(1) Post-October currency loss.
(2) Net foreign currency loss.
(3) Foreign currency gain or loss.
(e) Limitation on capital gain dividends.
(1) In general.
(2) Amount taken into account in current year.
(i) Net capital loss.
(ii) Net long-term capital loss.
(3) Amount taken into account in succeeding year.
(f) Regulated investment company may elect to defer certain losses for purposes of determining taxable income.
(1) In general.
(2) Effect of election in current year.
(3) Amount of loss taken into account in current year.
(i) If entire amount of net capital loss deferred.
(ii) If part of net capital loss deferred.
(A) In general.
(B) Character of capital loss not deferred.
(iii) If entire amount of net long-term capital loss deferred.
(iv) If part of net long-term capital loss deferred.
(v) If entire amount of post-October currency loss deferred.
(vi) If part of post-October currency loss deferred.
(4) Amount of loss taken into account in succeeding year and subsequent years.
(5) Effect on gross income.
(g) Earnings and profits.
(1) General rule.
(2) Special rule—treatment of losses that are deferred for purposes of determining taxable income.
(h) Examples.
(i) Procedure for making election.
(1) In general.
(2) When applicable instructions not available.
(j) Transition rules.
(1) In general.
(2) Retroactive election.
(i) In general.
(ii) Deadline for making election.
(3) Amended return required for succeeding year in certain circumstances.
(i) In general.
(ii) Time for filing amended return.
(4) Retroactive dividend.
(i) In general.
(ii) Method of making election.
(iii) Deduction for dividends paid.
(A) In general.
(B) Limitation on ordinary dividends.
(C) Limitation on capital gain dividends.
(D) Effect on other years.
(iv) Earnings and profits.
(v) Receipt by shareholders.
(vi) Foreign tax election.
(vii) Example.
(5) Certain distributions may be designated retroactively as capital gain dividends.
(k) Effective date.

(b) *Scope*—(1) *In general.* This section prescribes the manner in which a regulated investment company must treat a post-October capital loss (as defined in paragraph (c) of this section) or a post-October currency loss (as defined in paragraph (d)(1) of this section) for purposes of determining its taxable income, its earnings and profits, and the

amount that it may designate as capital gain dividends for the taxable year in which the loss is incurred and the succeeding taxable year (the ''succeeding year'').

(2) *Limitation on application of section.* This section shall not apply to any post-October capital loss or post-October currency loss of a regulated investment company attributable to a taxable year for which an election is in effect under section 4982(e)(4) of the Code with respect to the company.

(c) *Post-October capital loss defined*—(1) *In general.* For purposes of this section, the term *post-October capital loss* means—

(i) Any net capital loss attributable to the portion of a regulated investment company's taxable year after October 31; or

(ii) If there is no such net capital loss, any net long-term capital loss attributable to the portion of a regulated investment company's taxable year after October 31.

(2) *Methodology.* The amount of any net capital loss or any net long-term capital loss attributable to the portion of the regulated investment company's taxable year after October 31 shall be determined in accordance with general tax law principles (other than section 1212) by treating the period beginning on November 1 of the taxable year of the regulated investment company and ending on the last day of such taxable year as though it were the taxable year of the regulated investment company. For purposes of this paragraph (c)(2), any item (other than a capital loss carryover) that is required to be taken into account or any rule that must be applied, for purposes of section 4982, on October 31 as if it were the last day of the regulated investment company's taxable year must also be taken into account or applied in the same manner as required under section 4982, both on October 31 and again on the last day of the regulated investment company's taxable year.

(3) *October 31 treated as last day of taxable year for purpose of determining taxable income under certain circumstances*—(i) *In general.* If a regulated investment company has a post-October capital loss for a taxable year, any item that must be marked to market for purposes of section 4982 on October 31 as if it were the last day of the regulated investment company's taxable year must also be marked to market on October 31 and again on the last day of the regulated investment company's taxable year for purposes of determining its taxable income. If the regulated investment company does not have a post-October capital loss for a taxable year, the regulated investment company must treat items that must be marked to market for purposes of section 4982 on October 31 as if it were the last day of the regulated investment company's taxable year as marked to market only on the last day of its taxable year for purposes of determining its taxable income.

(ii) *Effect on gross income.* The marking to market of any item on October 31 of a regulated investment company's taxable year for purposes of determining its taxable income under paragraph (c)(3)(i) of this section shall not affect the amount of the gross income of such company for such taxable year for purposes of section 851(b) (2) or (3).

(d) *Post-October currency loss defined.* For purposes of this section—

(1) *Post-October currency loss.* The term *post-October currency loss* means any net foreign currency loss attributable to the portion of a regulated investment company's taxable year after October 31. For purposes of the preceding sentence, principles similar to those of paragraphs (c)(2) and (c)(3) of this section shall apply.

(2) *Net foreign currency loss.* The term ''net foreign currency loss'' means the excess of foreign currency losses over foreign currency gains.

(3) *Foreign currency gain or loss.* The terms ''foreign currency gain'' and ''foreign currency loss'' have the same meaning as provided in section 988(b).

(e) *Limitation on capital gain dividends*—(1) *In general.* For purposes of determining the amount a regulated investment company may designate as capital gain dividends for a taxable year, the amount of net capital gain for the taxable year shall be determined without regard to any post-October capital loss for such year.

(2) *Amount taken into account in current year*—(i) *Net capital loss.* If the post-October capital loss referred to in

paragraph (e)(1) of this section is a post-October capital loss as defined in paragraph (c)(1)(i) of this section, the net capital gain of the company for the taxable year in which the loss arose shall be determined without regard to any capital gains or losses (both long-term and short-term) taken into account in computing the post-October capital loss for the taxable year.

(ii) *Net long-term capital loss.* If the post-October capital loss referred to in paragraph (e)(1) of this section is a post-October capital loss as defined in paragraph (c)(1)(ii) of this section, the net capital gain of the company for the taxable year in which the loss arose shall be determined without regard to any long-term capital gain or loss taken into account in computing the post-October capital loss for the taxable year.

(3) *Amount taken into account in succeeding year.* If a regulated investment company has a post-October capital loss (as defined in paragraph (c)(1)(i) or (c)(1)(ii) of this section) for any taxable year, then, for purposes of determining the amount the company may designate as capital gain dividends for the succeeding year, the net capital gain for the succeeding year shall be determined by treating all gains and losses taken into account in computing the post-October capital loss as arising on the first day of the succeeding year.

(f) *Regulated investment company may elect to defer certain losses for purposes of determining taxable income*—(1) *In general.* A regulated investment company may elect, in accordance with the procedures of paragraph (i) of this section, to compute its taxable income for a taxable year without regard to part or all of any post-October capital loss or post-October currency loss for that year.

(2) *Effect of election in current year.* The taxable income of a regulated investment company for a taxable year to which an election under paragraph (f)(1) of this section applies shall be computed without regard to that part of any post-October capital loss or post-October currency loss to which the election applies.

(3) *Amount of loss taken into account in current year*—(i) *If entire amount of net capital loss deferred.* If a regulated investment company elects, under paragraph (f)(1) of this section, to defer the entire amount of a post-October capital loss as defined in paragraph (c)(1)(i) of this section, the taxable income of the company for the taxable year in which the loss arose shall be determined without regard to any capital gains or losses (both long-term and short-term) taken into account in computing the post-October capital loss for the taxable year.

(ii) *If part of net capital loss deferred*—(A) *In general.* If a regulated investment company elects, under paragraph (f)(1) of this section, to defer less than the entire amount of a post-October capital loss as defined in paragraph (c)(1)(i) of this section, the taxable income of the company for the taxable year in which the loss arose shall be determined by including an amount of capital loss taken into account in computing the post-October capital loss for the taxable year equal to the amount of the post-October capital loss that is not deferred. No amount of capital gain taken into account in computing the post-October capital loss for the taxable year shall be taken into account in the determination.

(B) *Character of capital loss not deferred.* The capital loss includible in the taxable income of the company under this paragraph (f)(3)(ii) for the taxable year in which the loss arose shall consist first of any short-term capital losses to the extent thereof, and then of any long-term capital losses, taken into account in computing the post-October capital loss for the taxable year.

(iii) *If entire amount of net long-term capital loss deferred.* If a regulated investment company elects, under paragraph (f)(1) of this section, to defer the entire amount of a post-October capital loss as defined in paragraph (c)(1)(ii) of this section, the taxable income of the company for the taxable year in which the loss arose shall be determined without regard to any long-term capital gains or losses taken into account in computing the post-October capital loss for the taxable year.

(iv) *If part of net long-term capital loss deferred.* If a regulated investment company elects, under paragraph (f)(1) of this section, to defer less than the

entire amount of a post-October capital loss as defined in paragraph (c)(1)(ii) of this section, the taxable income of the company for the taxable year in which the loss arose shall be determined by including an amount of long-term capital loss taken into account in computing the post-October capital loss for the taxable year equal to the amount of the post-October capital loss that is not deferred. No amount of long term capital gain taken into account in computing the post-October capital loss for the taxable year shall be taken into account in the determination.

(v) *If entire amount of post-October currency loss deferred.* If a regulated investment company elects, under paragraph (f)(1) of this section, to defer the entire amount of a post-October currency loss, the taxable income of the company for the taxable year in which the loss arose shall be determined without regard to any foreign currency gains or losses taken into account in computing the post-October currency loss for the taxable year.

(vi) *If part of post-October currency loss deferred.* If a regulated investment company elects, under paragraph (f)(1) of this section, to defer less than the entire amount of a post-October currency loss, the taxable income of the company for the taxable year in which the loss arose shall be determined by including an amount of foreign currency loss taken into account in computing the post-October currency loss for the taxable year equal to the amount of the post-October currency loss that is not deferred. No amount of foreign currency gain taken into account in computing the post-October currency loss for the taxable year shall be taken into account in the determination.

(4) *Amount of loss taken into account in succeeding year and subsequent years.* If a regulated investment company has a post-October capital loss or a post-October currency loss for any taxable year and an election under paragraph (f)(1) is made for that year, then, for purposes of determining the taxable income of the company for the succeeding year and all subsequent years, all capital gains and losses taken into account in determining the post-October capital loss, and all foreign currency gains and losses taken into account in determining the post-October currency loss, that are not taken into account under the rules of paragraph (f)(3) of this section in determining the taxable income of the regulated investment company for the taxable year in which the loss arose shall be treated as arising on the first day of the succeeding year.

(5) *Effect on gross income.* An election by a regulated investment company to defer any post-October capital loss or any post-October currency loss for a taxable year under paragraph (f)(1) of this section shall not affect the amount of the gross income of such company for such taxable year (or the succeeding year) for purposes of section 851(b) (2) or (3).

(g) *Earnings and profits*—(1) *General rule.* The earnings and profits of a regulated investment company for a taxable year are determined without regard to any post-October capital loss or post-October currency loss for that year. If a regulated investment company distributes with respect to a calendar year amounts in excess of the limitation described in the succeeding sentence, then, with respect to those excess amounts, for the taxable year with respect to which the amounts are distributed, the earnings and profits of the company are computed without regard to the preceding sentence. The limitation described in this sentence is the amount that would be the required distribution for that calendar year under section 4982 if ''100 percent'' were substituted for each percentage set forth in section 4982(b)(1).

(2) *Special Rule—Treatment of losses that are deferred for purposes of determining taxable income.* If a regulated investment company elects to defer, under paragraph (f)(1) of this section, any part of a post-October capital loss or post-October currency loss arising in a taxable year, then, for both the taxable year in which the loss arose and the succeeding year, both the earnings and profits and the accumulated earnings and profits of the company are determined as if the part of the loss so deferred had arisen on the first day of the succeeding year.

(h) *Examples.* The provisions of paragraphs (e), (f), and (g) of this section

may be illustrated by the following examples. For each example, assume that X is a regulated investment company that computes its income on a calendar year basis, and that no election is in effect under section 4982(e)(4).

Example 1. X has a $25 net foreign currency gain, a $50 net short-term capital loss, and a $75 net long-term capital gain for the post-October period of 1988. X has no post-October currency loss and no post-October capital loss for 1988, and this section does not apply.

Example 2. X has the following capital gains and losses for the periods indicated:

	Long-term	Short-term
01/01 to 10/31/88	115 (15)	80 (20)
	100	60
11/01 to 12/31/88	75 (150)	150 (50)
	(75)	100
01/01 to 10/31/89	30 (5)	40 (20)
	25	20
11/01 to 12/31/89	35 (0)	100 (50)
	35	50

X has a post-October capital loss of $75 for its 1988 taxable year due to a net long-term capital loss for the post-October period of 1988. X does not make an election under paragraph (f)(1) of this section.

(i) *Capital gain dividends.* X may designate up to $100 as a capital gain dividend for 1988 because X must disregard the $75 long-term capital gain and the $150 long-term capital loss for the post-October period of 1988 in computing its net capital gain for this purpose. In computing its net capital gain for 1989 for the purposes of determining the amount it may designate as a capital gain dividend for 1989, X must take into account the $75 long-term capital gain and the $150 long-term capital loss for the post-October period of 1988 in addition to the long-term and short-term capital gains and losses for 1989. Accordingly, X may not designate any amount as a capital gain dividend for 1989.

(ii) *Taxable income.* X must include the $75 long-term capital gain and the $150 long-term capital loss for its post-October period of 1988 in its taxable income for 1988 because it did not make an election under paragraph (f)(1) of this section for 1988. Accordingly, X's taxable income for 1988 will include a net capital gain of $25 and a net short-term capital gain of $160. X's taxable income for 1989 will include a net capital gain of $60 and a net short-term capital gain of $70.

(iii) *Earnings and profits.* X must determine its earnings and profits for 1988 without regard to the $75 long-term capital gain and the $150 long-term capital loss for the post-October period of 1988. X must, however, include the $75 long-term capital gain and $150 long-term capital loss for the post-October period of 1988 in determining its accumulated earnings and profits for 1988. Thus, X includes $260 of capital gain in its earnings and profits for 1988, includes $185 in its accumulated earnings and profits for 1988, and includes $130 of capital gain in its earnings and profits for 1989.

Example 3. Same facts as example 2, except that X elects to defer the entire $75 post-October capital loss for 1988 under paragraph (f)(1) of this section for purposes of determining its taxable income for 1988.

(i) *Capital gain dividends.* Same result as in example 2.

(ii) *Taxable income.* X must compute its taxable income for 1988 without regard to the $75 long-term capital gain and the $150 long-term capital loss for the post-October period of 1988 because it made an election to defer the entire $75 post-October capital loss for 1988 under paragraph (f)(1) of this section. Accordingly, X's taxable income for 1988 will include a net capital gain of $100 and a net short-term capital gain of $160. X must include the $75 long-term capital gain and the $150 long-term capital loss for the post-October period of 1988 in its taxable income for 1989 in addition to the long-term and short-term capital gains and losses for 1989. Accordingly, X's taxable income for 1989 will include a net long-term capital loss of $15 and a net short-term capital gain of $70.

(iii) *Earnings and profits.* For 1988, X must determine both its earnings and profits and its accumulated earnings and profits without regard to the $75 long-term capital gain and $150 long-term capital loss for the post-October period of 1988. In determining both its earnings and profits and its accumulated earnings and profits for 1989, X must include (in addition to the long-term and short-term capital gains and losses for 1989) the $75 long-term capital gain and $150 long-term capital loss for the post-October period of 1988 as if those deferred gains and losses arose on January 1, 1989. Thus, X will include $260 of capital gain in its earnings and profits for 1988 and $55 of capital gain in its earnings and profits for 1989.

Example 4. Same facts as example 2, except that X elects to defer only $50 of the post-October capital loss for 1988 under paragraph (f)(1) of this section for purposes of determining its taxable income for 1988.

(i) *Capital gain dividends.* Same results as in example 2.

(ii) *Taxable income.* X must compute its taxable income for 1988 without regard to the

$75 long-term capital gain and $125 of the $150 long-term capital loss for the post-October period of 1988 because it made an election to defer $50 of the $75 post-October capital loss for 1988 under paragraph (f)(1) of this section. Accordingly, X's taxable income for 1988 will include a net capital gain of $75 and a net short-term capital gain of $160. X must include the $75 long-term capital gain and $125 of the $150 long-term capital loss for the post-October period of 1988 in its taxable income for 1989 in addition to the long-term and short-term capital gains and losses for 1989. Accordingly, X's taxable income for 1989 will include a net capital gain of $10 and a net short-term capital gain of $70.

(iii) *Earnings and profits.* X must determine its earnings and profits for 1988 without regard to the $75 long-term capital gain and the $150 long-term capital loss for the post-October period of 1988. X must include $25 of the $150 long-term capital loss for the post-October period of 1988 in determining its accumulated earnings and profits for 1988. In determining both its earnings and profits and its accumulated earnings and profits for 1989, X must include (in addition to the long-term and short-term capital gains and losses for 1989) the $75 long-term capital gain and $125 of the $150 long-term capital loss for the post-October period of 1988 as if those deferred gains and losses arose on January 1, 1989. Thus, X includes $260 of capital gain in its earnings and profits for 1988, includes $235 in its accumulated earnings and profits for 1988, and includes $80 of capital gain in its earnings and profits for 1989.

Example 5. X has the following capital gains and losses for the periods indicated:

	Long-term	Short-term
01/01 to 10/31/88	115 (15)	80 (20)
	100	60
11/01 to 12/31/88	150 (75)	50 (150)
	75	(100)
01/01 to 10/31/89	30 (5)	40 (20)
	25	20
11/01 to 12/31/89	35 (0)	100 (50)
	35	50

X has a post-October capital loss of $25 for its 1988 taxable year due to a net capital loss for the post-October period of 1988. X does not make an election under paragraph (f)(1) of this section.

(i) *Capital gain dividends.* X may designate up to $100 as a capital gain dividend for 1988 because X must disregard the $150 long-term capital gain, the $75 long-term capital loss, the $50 short-term capital gain, and the $150 short-term capital loss for the post-October period of 1988 in computing its net capital gain for this purpose. In computing its net capital gain for 1989 for purposes of determining the amount it may designate as a capital gain dividend for 1989, X must take into account the $150 long-term capital gain, the $75 long-term capital loss, the $50 short-term capital gain, and the $150 short-term capital loss for the post-October period of 1988 in addition to the long-term and short-term capital gains and losses for 1989. Accordingly, X may designate up to $105 as a capital gain dividend for 1989.

(ii) *Taxable income.* X must include the $150 long-term capital gain, the $75 long-term capital loss, the $50 short-term capital gain, and the $150 short-term capital loss for the post-October period of 1988 in its taxable income for 1988 because it did not make an election under paragraph (f)(1) of this section for 1988. Accordingly, X's taxable income for 1988 will include a net capital gain of $135 (consisting of a net long-term capital gain of $175 and a net short-term capital loss of $40). X's taxable income for 1989 will include a net capital gain of $60 and a net short-term capital gain of $70.

(iii) *Earnings and profits.* X must determine its earnings and profits for 1988 without regard to the $150 long-term capital gain, the $75 long-term capital loss, the $50 short-term capital gain, and the $150 short-term capital loss for the post-October period of 1988. X must, however, include the $150 long-term capital gain, the $75 long-term capital loss, the $50 short-term capital gain, and the $150 short-term capital loss for the post-October period of 1988 in determining its accumulated earnings and profits for 1988. Thus, X includes $160 of capital gain in its earnings and profits for 1988, includes $135 in its accumulated earnings and profits for 1988, and includes $130 of capital gain in its earnings and profits for 1989.

Example 6. Same facts as example 5, except that X elects to defer the entire $25 post-October capital loss for 1988 under paragraph (f)(1) of this section for purposes of determining its taxable income for 1988.

(i) *Capital gain dividends.* Same result as in example 5.

(ii) *Taxable income.* X must compute its taxable income for 1988 without regard to the $150 long-term capital gain, the $75 long-term capital loss, the $50 short-term capital gain, and the $150 short-term capital loss for the post-October period of 1988 because it made an election to defer the entire $25 post-October capital loss for 1988 under paragraph (f)(1) of this section. Accordingly, X's taxable income for 1988 will include a net capital gain of $100 and a net short-term capital gain of $60. X must include the $150 long-

term capital gain, the $75 long-term capital loss, the $50 short-term capital gain, and the $150 short-term capital loss for the post-October period of 1988 in its taxable income for 1989 in addition to the long-term and short-term capital gains and losses for 1989. Accordingly, X's taxable income for 1989 will include a net capital gain of $105 (consisting of a net long-term capital gain of $135 and a net short-term capital loss of $30).

(iii) *Earnings and profits.* For 1988, X must determine both its earnings and profits and its accumulated earnings and profits without regard to the $150 long-term capital gain, the $75 long-term capital loss, the $50 short-term capital gain, and the $150 short-term capital loss for the post-October period of 1988. In determining both its earnings and profits and its accumulated earnings and profits for 1989, X must include (in addition to the long-term and short-term capital gains and losses for 1989) the $150 long-term capital gain, the $75 long-term capital loss, the $50 short-term capital gain, and the $150 short-term capital loss for the post-October period of 1988 as if those deferred gains and losses arose on January 1, 1989. Thus, X will include $160 of capital gain in its earnings and profits for 1988 and $105 of capital gain in its earnings and profits for 1989.

Example 7. Same facts as example 5, except that X elects to defer only $20 of the post-October capital loss for 1988 under paragraph (f)(1) of this section for purposes of determining its taxable income for 1988.

(i) *Capital gain dividends.* Same result as in example 5.

(ii) *Taxable income.* X must compute its taxable income for 1988 by including $5 of the $150 short-term capital loss for the post-October period of 1988, but without regard to the $150 long-term capital gain, the $75 long-term capital loss, the $50 short-term capital gain, and $145 of the $150 short-term capital loss for the post-October period of 1988 because it made an election to defer $20 of the $25 post-October capital loss for 1988 under paragraph (f)(1) of this section. Accordingly, X's taxable income for 1988 will include a net capital gain of $100 and a net short-term capital gain of $55. X must include the $150 long-term capital gain, the $75 long-term capital loss, the $50 short-term capital gain, and $145 of the $150 short-term capital loss for the post-October period of 1988 in its taxable income for 1989 in addition to the long-term and short-term capital gains and losses for 1989. Accordingly, X's taxable income for 1989 will include a net capital gain of $110 (consisting of a long-term capital gain of $135 and a net short-term capital loss of $25).

(iii) *Earnings and profits.* X must determine its earnings and profits for 1988 without regard to the $150 long-term capital gain, the $75 long-term capital loss, the $50 short-term capital gain, and the $150 short-term capital loss for the post-October period of 1988. In determining its accumulated earnings and profits for 1988, X must include $5 of the $150 short-term capital loss for the post-October period of 1988. In determining its accumulated earnings and profits for 1989, X must include (in addition to the long-term and short-term capital gains and losses for 1989) the $150 long-term capital gain, the $75 long-term capital loss, the $50 short-term capital gain, and $145 of the $150 short-term capital loss for the post-October period of 1988 as if those deferred gains and losses arose on January 1, 1989. Thus, X includes $160 of capital gain in its earnings and profits for 1988, includes $155 in its accumulated earnings and profits for 1988, and includes $110 of capital gain in its earnings and profits for 1989.

Example 8. X has the following capital gains and losses for the periods indicated:

	Long-term	Short-term
01/01 to 10/31/88	115 (15)	80 (20)
	100	60
11/01 to 12/31/88	15 (75)	25 (10)
	(60)	15
01/01 to 10/31/89	80 (5)	50 (100)
	75	(50)
11/01 to 12/31/89	85 (0)	40 (20)
	85	20

X has a post-October capital loss of $45 for its 1988 taxable year due to a net capital loss for the post-October period of 1988. X does not make an election under paragraph (f)(1) of this section.

(i) *Capital gain dividends.* X may designate up to $100 as a capital gain dividend for 1988 because X must disregard the $15 long-term capital gain, the $75 long-term capital loss, the $25 short-term capital gain, and the $10 short-term capital loss for the post-October period of 1988 in computing its net capital gain for this purpose. In computing its net capital gain for 1989 for purposes of determining the amount it may designate as a capital gain dividend for 1989, X must take into account the $15 long-term capital gain, the $75 long-term capital loss, the $25 short-term capital gain, and the $10 short-term capital loss for the post-October period of 1988 in addition to the long-term and short-term capital gains and losses for 1989. Accordingly, X may designate up to $85 as a capital gain dividend for 1989.

(ii) *Taxable income.* X must include the $15 long-term capital gain, the $75 long-term capital loss, the $25 short-term capital gain,

and the $10 short-term capital loss for the post-October period of 1988 in its taxable income for 1988 because it did not make an election under paragraph (f)(1) of this section for 1988. Accordingly, X's taxable income for 1988 will include a net capital gain of $40 and a net short-term capital gain of $75. X's taxable income for 1989 will include a net capital gain of $130 for 1989 (consisting of a net long-term capital gain of $160 and a net short-term capital loss of $30).

(iii) *Earnings and profits.* X must determine its earnings and profits for 1988 without regard to the $15 long-term capital gain, the $75 long-term capital loss, the $25 short-term capital gain, and the $10 short-term capital loss for the post-October period of 1988. X must, however, include the $15 long-term capital gain, the $75 long-term capital loss, the $25 short-term capital gain, and the $10 short-term capital loss for the post-October period of 1988 in determining its accumulated earnings and profits for 1988. Thus, X includes $160 of capital gain in its earnings and profits for 1988, includes $115 in its accumulated earnings and profits for 1988, and includes $130 of capital gain in its earnings and profits for 1989.

Example 9. Same facts as example 8, except that X elects to defer the entire $45 post-October capital loss for 1988 under paragraph (f)(1) of this section for purposes of determining its taxable income for 1988.

(i) *Capital gain dividends.* Same result as in example 8.

(ii) *Taxable income.* X must compute its taxable income for 1988 without regard to the $15 long-term capital gain, the $75 long-term capital loss, the $25 short-term capital gain, and the $10 short-term capital loss for the post-October period of 1988 because it made an election to defer the entire $45 post-October capital loss for 1988 under paragraph (f)(1) of this section. Accordingly, X's taxable income for 1988 will include a net capital gain of $100 and a net short-term capital gain of $60. X must include the $15 long-term capital gain, the $75 long-term capital loss, the $25 short-term capital gain, and the $10 short-term capital loss for the post-October period of 1988 in its taxable income for 1989 in addition to the long-term and short-term capital gains and losses for 1989. Accordingly, X's taxable income for 1989 will include a net capital gain of $85 (consisting of a net long-term capital gain of $100 and a net short-term capital loss of $15).

(iii) *Earnings and profits.* For 1988, X must determine both its earnings and profits and its accumulated earnings and profits without regard to the $15 long-term capital gain, the $75 long-term capital loss, the $25 short-term capital gain, and the $10 short-term capital loss for the post-October period of 1988. In determining both its earnings and profits and its accumulated earnings and profits for 1989, X must include (in addition to the long-term and short-term capital gains and losses for 1989) the $15 long-term capital gain, the $75 long-term capital loss, the $25 short-term capital gain, and the $10 short-term capital loss for the post-October period of 1988 as if those deferred gains and losses arose on January 1, 1989. Thus, X will include $160 of capital gain in its earnings and profits for 1988 and $85 of capital gain in its earnings and profits for 1989.

Example 10. Same facts as example 8, except that X elects to defer only $30 of the post-October capital loss for 1988 under paragraph (f)(1) of this section for purposes of determining its taxable income for 1988.

(i) *Capital gain dividends.* Same result as in example 8.

(ii) *Taxable income.* X must compute its taxable income for 1988 by including $5 of the $75 long-term capital loss and the $10 short-term capital loss for the post-October period of 1988, but without regard to the $15 long-term capital gain, $70 of the $75 long-term capital loss, and the $25 short-term capital gain for the post-October period of 1988 because it made an election to defer $30 of the $45 post-October capital loss for 1988 under paragraph (f)(1) of this section. Accordingly, X's taxable income for 1988 will include a net capital gain of $95 and a net short-term capital gain of $50. X must include the $15 long-term capital gain, $70 of the $75 long-term capital loss, and the $25 short-term capital gain for the post-October period of 1988 in its taxable income for 1989 in addition to the long-term and short-term capital gains and losses for 1989. Accordingly, X's taxable income for 1989 will include a net capital gain of $100 (consisting of a net long-term capital gain of $105 and a net short-term capital loss of $5).

(iii) *Earnings and profits.* X must determine its earnings and profits for 1988 without regard to the $15 long-term capital gain, the $75 long-term capital loss, the $25 short-term capital gain, and the $10 short-term capital loss for the post-October period of 1988. In determining its accumulated earnings and profits for 1988, X must include $5 of the $75 long-term capital loss and the $10 short-term capital loss for the post-October period of 1988. In determining both its earnings and profits and its accumulated earnings and profits for 1989, X must include (in addition to the long-term and short-term capital gains and losses for 1989) the $15 long-term capital gain, $70 of the $75 long-term capital loss, and the $25 short-term capital gain for the post-October period of 1988 as if those deferred gains and losses arose on January 1, 1989. Thus, X includes $160 of capital gain in its earnings and profits for 1988, includes $145 in its accumulated earnings and profits for 1989, and includes $100 of capital gain in its earnings and profits for 1989 (consisting of a net long-term capital gain of $105 and a net short-term capital loss of $5).

Example 11. X has the following foreign currency gains and losses attributable to the periods indicated:

01/01 to 10/31/88	200
11/01 to 12/31/88	(100)
01/01 to 10/31/89	110
11/01 to 12/31/89	40

X has a $100 post-October currency loss for its 1988 taxable year due to a net foreign currency loss for the post-October period of 1988. X does not make an election under paragraph (f)(1) of this section.

(i) *Taxable income.* X must compute its taxable income for 1988 by including the $100 foreign currency loss for the post-October period of 1988 because it did not make an election under paragraph (f)(1) of this section. Accordingly, X's taxable income for 1988 will include a net foreign currency gain of $100. X's taxable income for 1989 will include a net foreign currency gain of $150.

(ii) *Earnings and profits.* X must determine its earnings and profits for 1988 without regard to the foreign currency loss for the post-October period of 1988. X must, however, include the $100 foreign currency loss for the post-October period 1988 in determining its accumulated earnings and profits for 1988. Thus, X includes $200 of foreign currency gain in its earnings and profits for 1988, includes $100 in its accumulated earnings and profits for 1988, and includes $150 of foreign currency gain in its earnings and profits for 1989.

Example 12. Same facts as example 11, except that X elects to defer the entire $100 post-October currency loss for 1988 under paragraph (f)(1) of this section for purposes of determining its taxable income for 1988.

(i) *Taxable income.* X must compute its taxable income for 1988 without regard to the $100 foreign currency loss for the post-October period of 1988 because it made an election to defer the entire $100 post-October currency loss for 1988 under paragraph (f)(1) of this section. Accordingly, X's taxable income for 1988 will include a net foreign currency gain of $200. X's taxable income for 1989 will include a net foreign currency gain of $50 because X must compute its taxable income for 1989 by including the $100 foreign currency loss for the post-October period of 1988 in addition to the foreign currency gains and losses for 1989.

(ii) *Earnings and profits.* For 1988, X must determine both its earnings and profits and its accumulated earnings and profits without regard to the $100 foreign currency loss for the post-October period of 1988. In determining both its earnings and profits and its accumulated earnings and profits for 1989, X must include (in addition to the foreign currency gains and losses for 1989) the $100 foreign currency loss for the post-October period 1988 as if that deferred loss arose on January 1, 1989. Thus, X will include $200 of foreign currency gain in its earnings and profits for 1988 and $50 of foreign currency gain in its earnings and profits for 1989.

Example 13. Same facts as example 11, except that X elects to defer only $75 of the post-October currency loss under paragraph (f)(1) of this section for purposes of determining its taxable income for 1988.

(i) *Taxable income.* X must compute its taxable income for 1988 by including $25 of the $100 foreign currency loss for the post-October period of 1988, but without regard to $75 of the $100 foreign currency loss for the post-October period of 1988 because it made an election to defer $75 of the $100 post-October currency loss for 1988 under paragraph (f)(1) of this section. Accordingly, X's taxable income for 1988 will include a net foreign currency gain of $175. X's taxable income will include a net foreign currency gain of $75 for 1989 because X must compute its taxable income for 1989 by including $75 of the $100 foreign currency loss for the post-October period of 1988 in addition to the foreign currency gains and losses for 1989.

(ii) *Earnings and profits.* X must determine its earnings and profits for 1988 without regard to the $100 foreign currency loss for the post-October period of 1988. X must, however, inlcude $25 of the $100 foreign currency loss for the post-October period of 1988 in determining its accumulated earnings and profits for 1988. In determining both its earnings and profits and its accumulated earnings and profits for 1989, X must include (in addition to the foreign currency gains and losses for 1989) the $75 of the $100 foreign currency loss for the post-October period of 1988 as if that loss arose on January 1, 1989. Thus, X includes $200 of foreign currency gain in its earnings and profits for 1988, includes $175 in its accumulated earnings and profits for 1988, and includes $75 of foreign currency gain in its earnings and profits for 1989.

(i) *Procedure for making election*—(1) *In general.* Except as provided in paragraph (i)(2) of this section, a regulated investment company may make an election under paragraph (f)(1) of this section for a taxable year to which this section applies by completing its income tax return (including any necessary schedules) for that taxable year in accordance with the instructions for the form that are applicable to the election.

(2) *When applicable instructions not available.* If the instructions for the income tax returns of regulated investment companies for a taxable year to which this section applies do not reflect the provisions of this section, a regulated investment company may make an election under paragraph (f)(1)

of this section for that year by entering the appropriate amounts on its income tax return (including any necessary schedules) for that year, and by attaching a written statement to the return that states—

(i) The taxable year for which the election under this section is made;

(ii) The fact that the regulated investment company elects to defer all or a part of its post-October capital loss or post-October currency loss for that taxable year for purposes of computing its taxable income under the terms of this section;

(iii) The amount of the post-October capital loss or post-October currency loss that the regulated investment company elects to defer for that taxable year; and

(iv) The name, address, and employer identification number of the regulated investment company.

(j) *Transition rules*—(1) *In general.* For a taxable year ending before March 2, 1990 in which a regulated investment company incurred a post-October capital loss or post-October currency loss, the company may use any method that is consistently applied and in accordance with reasonable business practice to determine the amounts taken into account in that taxable year for purposes of paragraphs (e)(2), (f)(3), and (g) of this section and to determine the amount taken into account in the succeeding year for purposes of paragraphs (e)(3), (f)(4), and (g) of this section. For example, for purposes of paragraph (e), a taxpayer may use a method that treats as incurred in a taxable year all capital gains taken into account in computing the post-October capital loss for that year and an amount of capital loss for such period equal to the amount of such gains and that treats the remaining amount of capital loss for such period as arising on the first day of the succeeding year.

Similarly, for purposes of paragraph (e)(3), a taxpayer may use a method that treats as arising on the first day of the succeeding year only the excess of the capital losses from sales or exchanges after October 31 over the capital gains for such period (that is, the net capital loss or net long-term capital loss for such period).

(2) *Retroactive election*—(i) *In general.* A regulated investment company may make an election (a ''retroactive election'') under paragraph (f)(1) for a taxable year with respect to which it has filed an income tax return on or before May 1, 1990 (a ''retroactive election year'') by filing an amended return (including any necessary schedules) for the retroactive election year reflecting the appropriate amounts and by attaching a written statement to the return that complies with the requirements of paragraph (i)(2) of this section.

(ii) *Deadline for making election.* A retroactive election may be made no later than December 31, 1990.

(3) *Amended return required for succeeding year in certain circumstances*—(i) *In general.* If, at the time a regulated investment company makes a retroactive election under this section, it has already filed an income tax return for the succeeding year, the company must file an amended return for such succeeding year reflecting the appropriate amounts.

(ii) *Time for filing amended return.* An amended return required under paragraph (j)(3)(i) of this section must be filed together with the amended return described in paragraph (j)(2)(i).

(4) *Retroactive dividend*—(i) *In general.* A regulated investment company that makes a retroactive election under this section for a retroactive election year may elect to treat any dividend (or portion thereof) declared and paid (or treated as paid under section 852(b)(7)) by the regulated investment company after the retroactive election year and on or before December 31, 1990 as having been paid during the retroactive election year (a ''retroactive dividend''). This election shall be irrevocable with respect to the retroactive dividend to which it applies.

(ii) *Method of making election.* The election under this paragraph (j)(4) must be made by the regulated investment company by treating the dividend (or portion thereof) to which the election applies as a dividend paid during the retroactive election year in computing its deduction for dividends paid in its tax returns for all applicable years (including the amended return(s)

required to be filed under paragraphs (j)(2) and (3) of this section).

(iii) *Deduction for dividends paid*—(A) *In general.* Subject to the rules of sections 561 and 562, a regulated investment company shall include the amount of any retroactive dividend in computing its deduction for dividends paid for the retroactive election year. No deduction for dividends paid shall be allowed under this paragraph (j)(4)(iii)(A) for any amount not paid (or treated as paid under section 852(b)(7)) on or before December 31, 1990.

(B) *Limitation on ordinary dividends.* The amount of retroactive dividends (other than retroactive dividends qualifying as capital gain dividends) paid for a retroactive election year under this section shall not exceed the increase, if any, in the investment company taxable income of the regulated investment company (determined without regard to the deduction for dividends paid (as defined in section 561)) that is attributable solely to the regulated investment company having made the retroactive election.

(C) *Limitation on capital gain dividends.* The amount of retroactive dividends qualifying as capital gain dividends paid for a retroactive election year under this section shall not exceed the increase, if any, in the amount of the excess described in section 852(b)(3)(A) (relating to the excess of the net capital gain over the deduction for capital gain dividends paid) that is attributable solely to the regulated investment company having made the retroactive election.

(D) *Effect on other years.* A retroactive dividend shall not be includible in computing the deduction for dividends paid for—

(*1*) The taxable year in which such distribution is actually paid (or treated as paid under section 852(b)(7)); or

(*2*) Under section 855(a), the taxable year preceding the retroactive election year.

(iv) *Earnings and profits.* A retroactive dividend shall be considered as paid out of the earnings and profits of the retroactive election year (computed with the application of sections 852(c) and 855, § 1.852–5, § 1.855–1, and this section), and not out of the earnings and profits of the taxable year in which the distribution is actually paid (or treated as paid under section 852(b)(7)).

(v) *Receipt by shareholders.* Except as provided in section 852(b)(7), a retroactive dividend shall be included in the gross income of the shareholders of the regulated investment company for the taxable year in which the dividend is received by them.

(vi) *Foreign tax election.* If a regulated investment company to which section 853 (relating to foreign taxes) is applicable for a retroactive election year elects to treat a dividend paid (or treated as paid under section 852(b)(7)) during the taxable year as a retroactive dividend, the shareholders of the regulated investment company shall consider the amounts described in section 853(b)(2) allocable to such distribution as paid or received, as the case may be, in the shareholder's taxable year in which the distribution is made.

(vii) *Example.* The provisions of this paragraph (j)(4) may be illustrated by the following example:

Example. X is a regulated investment company that computes its income on a calendar year basis. No election is in effect under section 4982(e)(4). X has the following income for 1988:

FOREIGN CURRENCY GAINS AND LOSSES

Gains and Losses

Jan. 1–Oct. 31—100
Nov. 1–Dec. 31—(75)

CAPITAL GAINS AND LOSSES

Jan. 1–Oct. 31—short term, 100; long term, 100
Nov. 1–Dec. 31—short term, 50; long term, (100)

(A) X had investment company taxable income of $175 and no net capital gain for 1988 for taxable income purposes. X distributed $175 of investment company taxable income as an ordinary dividend for 1988.

(B) If X makes a retroactive election under this section to defer the entire $75 post-October currency loss and the entire $50 post-October capital loss for the post-October period of its 1988 taxable year for purposes of computing its taxable income, that deferral increases X's investment company taxable income for 1988 by $25 (due to an increase in foreign currency gain of $75 and a decrease in short-term capital gain of $50) to $200 and increases the excess described in section 852(b)(3)(A) for 1988 by $100 from $0 to $100.

The amount that X may treat as a retroactive ordinary dividend is limited to $25, and the amount that X may treat as a retroactive capital gain dividend is limited to $100.

(5) *Certain distributions may be designated retroactively as capital gain dividends.* To the extent that a regulated investment company designated as capital gain dividends for a taxable year less than the maximum amount permitted under paragraph (e) of this section for that taxable year, the regulated investment company may designate an additional amount of dividends paid (or treated as paid under sections 852(b)(7) or 855, or paragraph (j)(4) of this section) for the taxable year as capital gain dividends, notwithstanding that a written notice was not mailed to its shareholders within 60 days after the close of the taxable year in which the distribution was paid (or treated as paid under section 852(b)(7)).

(k) *Effective date.* the provisions of this section shall apply to taxable years ending after October 31, 1987.

[T.D. 8287, 55 FR 3213, Jan. 31, 1990; 55 FR 7891, Mar. 6, 1990; 55 FR 11110, Mar. 26, 1990. Redesignated and amended by T.D. 8320, 55 FR 50176, Dec. 5, 1990; 56 FR 2808, Jan. 24, 1991; 56 FR 8130, Feb. 27, 1991]

§ 1.852–12 Non-RIC earnings and profits.

(a) *Applicability of section 852(a)(2)(A)*—(1) *In general.* An investment company does not satisfy section 852(a)(2)(A) unless—

(i) Part I of subchapter M applied to the company for all its taxable years ending on or after November 8, 1983; and

(ii) For each corporation to whose earnings and profits the investment company succeeded by the operation of section 381, part I of subchapter M applied for all the corporation's taxable years ending on or after November 8, 1983.

(2) *Special rule.* See section 1071(a)(5)(D) of the Tax Reform Act of 1984, Public Law 98–369 (98 Stat. 1051), for a special rule which treats part I of subchapter M as having applied to an investment company's first taxable year ending after November 8, 1983.

(b) *Applicability of section 852(a)(2)(B)*—(1) *In general.* An investment company does not satisfy section 852(a)(2)(B) unless, as of the close of the taxable year, it has no earnings and profits other than earnings and profits that—

(i) Were earned by a corporation in a year for which part I of subchapter M applied to the corporation and, at all times thereafter, were the earnings and profits of a corporation to which part I of subchapter M applied;

(ii) By the operation of section 381 pursuant to a transaction that occurred before December 22, 1992, became the earnings and profits of a corporation to which part I of subchapter M applied and, at all times thereafter, were the earnings and profits of a corporation to which part I of subchapter M applied;

(iii) Were accumulated in a taxable year ending before January 1, 1984, by a corporation to which part I of subchapter M applied for any taxable year ending before November 8, 1983; or

(iv) Were accumulated in the first taxable year of an investment company that began business in 1983 and that was not a successor corporation.

(2) *Prior law.* For purposes of paragraph (b) of this section, a reference to part I of subchapter M includes a reference to the corresponding provisions of prior law.

(c) *Effective date.* This regulation is effective for taxable years ending on or after December 22, 1992.

(d) For treatment of net built-in gain assets of a C corporation that become assets of a RIC, see § 1.337(d)–5T.

[T.D. 8483, 58 FR 43798, Aug. 18, 1993; 58 FR 49352, Sept. 22, 1993; T.D. 8872, 65 FR 5777, Feb. 7, 2000]

§ 1.853–1 Foreign tax credit allowed to shareholders.

(a) *In general.* Under section 853, a regulated investment company, meeting the requirements set forth in section 853(a) and paragraph (b) of this section, may make an election with respect to the income, war-profits, and excess profits taxes described in section 901(b)(1) which it pays to foreign countries or possessions of the United States during the taxable year, including such taxes as are deemed paid by it under the provisions of any income tax convention to which the United States

is a party. If an election is made, the shareholders of the regulated investment company shall apply their proportionate share of such foreign taxes paid, or deemed to have been paid by it pursuant to any income tax convention, as either a credit (under section 901) or as a deduction (under section 164(a)) as provided by section 853(b)(2) and paragraph (b) of § 1.853–2. The election is not applicable with respect to taxes deemed to have been paid under section 902 (relating to the credit allowed to corporate stockholders of a foreign corporation for taxes paid by such foreign corporation). In addition, the election is not applicable to any tax with respect to which the regulated investment company is not allowed a credit by reason of any provision of the Internal Revenue Code other than section 853(b)(1), including, but not limited to, section 901(j), section 901(k), or section 901(l).

(b) *Requirements*. To qualify for the election provided in section 853(a), a regulated investment company (1) must have more than 50 percent of the value of its total assets, at the close of the taxable year for which the election is made, invested in stocks and securities of foreign corporations, and (2) must also, for that year, comply with the requirements prescribed in section 852(a) and paragraph (a) of § 1.852–1. The term ''value'', for purposes of the first requirement, is defined in section 851(c)(4). For the definition of foreign corporation, see section 7701(a).

(c) *Effective/applicability date*. The final sentence of paragraph (a) of this section is applicable for RIC taxable years ending on or after December 31, 2007.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 9357, 72 FR 48553, Aug. 24, 2007]

§ 1.853–2 Effect of election.

(a) *Regulated investment company*. A regulated investment company making a valid election with respect to a taxable year under the provisions of section 853(a) is, for such year, denied both the deduction for foreign taxes provided by section 164(a) and the credit for foreign taxes provided by section 901 with respect to all income, war-profits, and excess profits taxes (described in section 901(b)(1)) which it has paid to any foreign country or possession of the United States. See section 853(b)(1)(A). However, under section 853(b)(1)(B), the regulated investment company is permitted to add the amount of such foreign taxes paid to its dividends paid deduction for that taxable year. See paragraph (a) of § 1.852–1.

(b) *Shareholder*. Under section 853(b)(2), a shareholder of an investment company, which has made the election under section 853, is, in effect, placed in the same position as a person directly owning stock in foreign corporations, in that he must include in his gross income (in addition to taxable dividends actually received) his proportionate share of such foreign taxes paid and must treat such amount as foreign taxes paid by him for the purposes of the deduction under section 164(a) and the credit under section 901. For such purposes he must treat as gross income from a foreign country or possession of the United States (1) his proportionate share of the taxes paid by the regulated investment company to such foreign country or possession and (2) the portion of any dividend paid by the investment company which represents income derived from such sources.

(c) *Dividends paid after the close of the taxable year*. For additional rules applicable to certain distributions made after the close of the taxable year which may be designated as income received from sources within and taxes paid to foreign countries or possessions of the United States, see section 855(d) and paragraph (f) of § 1.855–1.

(d) *Example*. This section is illustrated by the following example:

Example. (i) *Facts*. X Corporation, a regulated investment company with 250,000 shares of common stock outstanding, has total assets, at the close of the taxable year, of $10 million ($4 million invested in domestic corporations, $3.5 million in Foreign Country A corporations, and $2.5 million in Foreign Country B corporations). X Corporation received dividend income of $800,000 from the following sources: $300,000 from domestic corporations, $250,000 from Country A corporations, and $250,000 from Country B corporations. All dividends from Country A corporations and from Country B corporations were properly characterized as income from sources without the United States. The dividends from Country A corporations were

subject to a 10 percent withholding tax ($25,000) and the dividends from Country B corporations were subject to a 20 percent withholding tax ($50,000). X Corporation's only expenses for the taxable year were $80,000 of operation and management expenses related to both its U.S. and foreign investments. In this case, Corporation X properly apportioned the $80,000 expense based on the relative amounts of its U.S. and foreign source gross income. Thus, $50,000 in expense was apportioned to foreign source income ($80,000 × $500,000 / $800,000, total expense times the fraction of foreign dividend income over total dividend income) and $30,000 in expense was apportioned to U.S. source income ($80,000 × $300,000 / $800,000, total expense times the fraction of U.S. source dividend income over total dividend income). During the taxable year, X Corporation distributed to its shareholders the entire $645,000 income that was available for distribution ($800,000, less $80,000 in expenses, less $75,000 in foreign taxes withheld).

(ii) *Section 853 election.* X Corporation meets the requirements of section 851 to be considered a RIC for the taxable year and the requirements of section 852(a) for part 1 of subchapter M to apply for the taxable year. X Corporation notifies each shareholder by mail, within the time prescribed by section 853(c), that by reason of the election the shareholders are to treat as foreign taxes paid $0.30 per share of stock ($75,000 of foreign taxes paid, divided by the 250,000 shares of stock outstanding). The shareholders must report as income $2.88 per share ($2.58 of dividends actually received plus the $0.30 representing foreign taxes paid). Of the $2.88 per share, $1.80 per share ($450,000 of foreign source taxable income divided by 250,000 shares) is to be considered as received from foreign sources. The $1.80 consists of $0.30, the foreign taxes treated as paid by the shareholder and $1.50, the portion of the dividends received by the shareholder from the RIC that represents income of the RIC treated as derived from foreign sources ($500,000 of foreign source income, less $50,000 of expense apportioned to foreign source income, less $75,000 of foreign tax withheld, which is $375,000, divided by 250,000 shares).

(e) *Effective/applicability date.* Paragraph (d) of this section is applicable for RIC taxable years ending on or after December 31, 2007. Notwithstanding the preceding sentence, for a taxable year that ends on or after December 31, 2007, and begins before August 24, 2007, a taxpayer may rely on this section as it was in effect on August 23, 2007.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 9357, 72 FR 48553, Aug. 24, 2007]

§ 1.853–3 Notice to shareholders.

(a) *General rule.* If a regulated investment company makes an election under section 853(a), in the manner provided in § 1.853–4, the regulated investment company is required under section 853(c) to furnish its shareholders with a written notice mailed not later than 60 days after the close of its taxable year. The notice must designate the shareholder's portion of creditable foreign taxes paid to foreign countries or possessions of the United States and the portion of the dividend that represents income derived from sources within each country that is attributable to a period during which section 901(j) applies to such country, if any, and the portion of the dividend that represents income derived from other foreign countries and possessions of the United States. For purposes of section 853(b)(2) and § 1.853–2(b), the amount that a shareholder may treat as the shareholder's proportionate share of foreign taxes paid and the amount to be included as gross income derived from any foreign country that is attributable to a period during which section 901(j) applies to such country or gross income from sources within other foreign countries or possessions of the United States shall not exceed the amount so designated by the regulated investment company in such written notice. If, however, the amount designated by the regulated investment company in the notice exceeds the shareholder's proper proportionate share of foreign taxes or gross income from sources within foreign countries or possessions of the United States, the shareholder is limited to the amount correctly ascertained.

(b) *Shareholder of record custodian of certain unit investment trusts.* In any case where a notice is mailed pursuant to paragraph (a) of this section by a regulated investment company with respect to a taxable year of the regulated investment company ending after December 8, 1970 to a shareholder of record who is a nominee acting as a

custodian of a unit investment trust described in section 851(f)(1) and paragraph (b) of § 1.851–7, the nominee shall furnish each holder of an interest in such trust with a written notice mailed on or before the 70th day following the close of the regulated investment company's taxable year. The notice shall designate the holder's proportionate share of the amounts of creditable foreign taxes paid to foreign countries or possessions of the United States and the holder's proportionate share of the dividend that represents income derived from sources within each country that is attributable to a period during which section 901(j) applies to such country, if any, and the holder's proportionate share of the dividend that represents income derived from other foreign countries or possessions of the United States shown on the notice received by the nominee pursuant to paragraph (a) of this section. This paragraph shall not apply if the regulated investment company agrees with the nominee to satisfy the notice requirements of paragraph (a) of this section with respect to each holder of an interest in the unit investment trust whose shares are being held by the nominee as custodian and not later than 45 days following the close of the company's taxable year, files with the Internal Revenue Service office where such company's return for the taxable year is to be filed, a statement that the holders of the unit investment trust with whom the agreement was made have been directly notified by the regulated investment company. Such statement shall include the name, sponsor, and custodian of each unit investment trust whose holders have been directly notified. The nominee's requirements under this paragraph shall be deemed met if the regulated investment company transmits a copy of such statement to the nominee within such 60-day period: *Provided however*, if the regulated investment company fails or is unable to satisfy the requirements of this paragraph with respect to the holders of interest in the unit investment trust, it shall so notify the Internal Revenue Service within 60 days following the close of its taxable year. The custodian shall, upon notice by the Internal Revenue Service that the regulated investment company has failed to comply with the agreement, satisfy the requirements of this paragraph within 30 days of such notice.

(c) *Effective/applicability date*. This section is applicable for RIC taxable years ending on or after December 31, 2007. Notwithstanding the preceding sentence, for a taxable year that ends on or after December 31, 2007, and begins before August 24, 2007, a taxpayer may rely on this section as it was in effect on August 23, 2007.

[T.D. 7187, 37 FR 13257, July 6, 1972, as amended by T.D. 9357, 72 FR 48554, Aug. 24, 2007]

§ 1.853–4 Manner of making election.

(a) *General rule*. To make an election under section 853 for a taxable year, a regulated investment company must file a statement of election as part of its Federal income tax return for the taxable year. The statement of election must state that the regulated investment company elects the application of section 853 for the taxable year and agrees to provide the information required by paragraph (c) of this section.

(b) *Irrevocability of the election*. The election shall be made with respect to all foreign taxes described in paragraph (c)(2) of this section, and must be made not later than the time prescribed for filing the return (including extensions). This election, if made, shall be irrevocable with respect to the dividend (or portion thereof), and the foreign taxes paid with respect thereto, to which the election applies.

(c) *Required information*. A regulated investment company making an election under section 853 must provide the following information:

(1) The total amount of taxable income received in the taxable year from sources within foreign countries and possessions of the United States and the amount of taxable income received in the taxable year from sources within each such foreign country or possession.

(2) The total amount of income, war profits, or excess profits taxes (described in section 901(b)(1)) to which the election applies that were paid in the taxable year to such foreign countries or possessions and the amount of such taxes paid to each such foreign country or possession.

(3) The amount of income, war profits, or excess profits taxes paid during the taxable year to which the election does not apply by reason of any provision of the Internal Revenue Code other than section 853(b), including, but not limited to, section 901(j), section 901(k), or section 901(l).

(4) The date, form, and contents of the notice to its shareholders.

(5) The proportionate share of creditable foreign taxes paid to each such foreign country or possession during the taxable year and foreign income received from sources within each such foreign country or possession during the taxable year attributable to one share of stock of the regulated investment company.

(d) *Time and manner of providing information.* The information specified in paragraph (c) of this section must be provided at the time and in the manner prescribed by the Commissioner and, unless otherwise prescribed, must be provided on or with a modified Form 1118 ''Foreign Tax Credit—Corporations'' filed as part of the RIC's timely filed Federal income tax return for the taxable year.

(e) *Effective/applicability date.* This section is applicable for RIC taxable years ending on or after December 31, 2007. Notwithstanding the preceding sentence, for a taxable year that ends on or after December 31, 2007, and begins before August 24, 2007, a taxpayer may rely on this section as it was in effect on August 23, 2007.

[T.D. 9357, 72 FR 48554, Aug. 24, 2007]

§ 1.854–1 Limitations applicable to dividends received from regulated investment company.

(a) *In general.* Section 854 provides special limitations applicable to dividends received from a regulated investment company for purposes of the exclusion under section 116 for dividends received by individuals, the deduction under section 243 for dividends received by corporations, and, in the case of dividends received by individuals before January 1, 1965, the credit under section 34.

(b) *Capital gain dividend.* Under the provisions of section 854(a) a capital gain dividend as defined in section 852(b)(3) and paragraph (c) of § 1.852–4 shall not be considered a dividend for purposes of the exclusion under section 116, the deduction under section 243, and, in the case of taxable years ending before January 1, 1965, the credit under section 34.

(c) *Rule for dividends other than capital gain dividends.* (1) Section 854(b)(1) limits the amount that may be treated as a dividend (other than a capital gain dividend) by the shareholder of a regulated investment company, for the purposes of the credit, exclusion, and deduction specified in paragraph (b) of this section, where the investment company receives substantial amounts of income (such as interest, etc.) from sources other than dividends from domestic corporations, which dividends qualify for the exclusion under section 116.

(2) Where the ''aggregate dividends received'' (as defined in section 854(b)(3)(B) and paragraph (b) of § 1.854–3) during the taxable year by a regulated investment company (which meets the requirements of section 852(a) and paragraph (a) of § 1.852–1 for the taxable year during which it paid such dividend) are less than 75 percent of its gross income for such taxable year (as defined in section 854(b)(3)(A) and paragraph (a) of § 1.854–3), only that portion of the dividend paid by the regulated investment company which bears the same ratio to the amount of such dividend paid as the aggregate dividends received by the regulated investment company, during the taxable year, bears to its gross income for such taxable year (computed without regard to gains from the sale or other disposition of stocks or securities) may be treated as a dividend for purposes of such credit, exclusion, and deduction.

(3) Subparagraph (2) of this paragraph may be illustrated by the following example:

Example. The XYZ regulated investment company meets the requirements of section 852(a) for the taxable year and has received income from the following sources:

Capital gains (from the sale of stock or securities)	$100,000
Dividends (from domestic sources other than dividends described in section 116(b))	70,000
Dividend (from foreign corporations)	5,000
Interest	25,000
Total	200,000
Expenses	20,000

Taxable income	180,000

The regulated investment company decides to distribute the entire $180,000. It distributes a capital gain dividend of $100,000 and a dividend of ordinary income of $80,000. The aggregate dividends received by the regulated investment company from domestic corporations ($70,000) is less than 75 percent of its gross income ($100,000) computed without regard to capital gains from sales of securities. Therefore, an apportionment is required. Since $70,000 is 70 percent of $100,000, out of every $1 dividend of ordinary income paid by the regulated investment company only 70 cents would be available for the credit, exclusion, or deduction referred to in section 854(b)(1). The capital gains dividend and the dividend received from foreign corporations are excluded from the computation.

(d) *Dividends received from a regulated investment company during taxable years of shareholders ending after July 31, 1954, and subject to the Internal Revenue Code of 1939.* For the application of section 854 to taxable years of shareholders of a regulated investment company ending after July 31, 1954, and subject to the Internal Revenue Code of 1939, see § 1.34–5 and § 1.116–2.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 6921, 32 FR 8756, June 20, 1967]

§ 1.854–2 Notice to shareholders.

(a) *General rule.* Section 854(b)(2) provides that the amount that a shareholder may treat as a dividend for purposes of the exclusion under section 116 for dividends received by individuals, the deduction under section 243 for dividends received by corporation, and, in the case of dividends received by individuals before January 1, 1965, the credit under section 34, shall not exceed the amount so designated by the company in a written notice to its shareholders mailed not later than 45 days (30 days for a taxable year ending before Feb. 26, 1964) after the close of the company's taxable year. If, however, the amount so designated by the company in the notice exceeds the amount which may be treated by the shareholder as a dividend for such purposes, the shareholder is limited to the amount as correctly ascertained under section 854(b)(1) and paragraph (c) of § 1.854–1.

(b) *Shareholder of record custodian of certain unit investment trusts.* In any case where a notice is mailed pursuant to paragraph (a) of this section by a regulated investment company with respect to a taxable year of the regulated investment company ending after December 8, 1970 to a shareholder of record who is a nominee acting as a custodian of a unit investment trust described in section 851(f)(1) and paragraph (d) of § 1.851–7, the nominee shall furnish each holder of an interest in such trust with a written notice mailed on or before the 55th day following the close of the regulated investment company's taxable year. The notice shall designate the holder's proportionate share of the amounts that may be treated as a dividend for purposes of the exclusion under section 116 for dividends received by individuals and the deduction under section 243 for dividends received by corporations shown on the notice received by the nominee pursuant to paragraph (a) of this section. This notice shall include the name and address of the nominee identified as such. This paragraph shall not apply if the regulated investment company agrees with the nominee to satisfy the notice requirements of paragraph (a) of this section with respect to each holder of an interest in the unit investment trust whose shares are being held by the nominee as custodian and not later than 45 days following the close of the company's taxable year, files with the Internal Revenue Service office where such company's return is to be filed for the taxable year, a statement that the holders of the unit investment trust with whom the agreement was made have been directly notified by the regulated investment company. Such statement shall include the name, sponsor, and custodian of each unit investment trust whose holders have been directly notified. The nominee's requirements under this paragraph shall be deemed met if the regulated investment company transmits a copy of such statement to the nominee within such 45-day period; provided however, if the regulated investment company fails or is unable to satisfy the requirements of this paragraph with respect to the holders of interest in the unit investment trust, it shall so notify the Internal Revenue Service within 45 days following the

close of its taxable year. The custodian shall, upon notice by the Internal Revenue Service that the regulated investment company has failed to comply with the agreement, satisfy the requirements of this paragraph within 30 days of such notice.

[T.D. 7187, 37 FR 13257, July 6, 1972]

§ 1.854–3 Definitions.

(a) For the purpose of computing the limitation prescribed by section 854(b)(1)(B) and paragraph (c) of § 1.854–1, the term ''gross income'' does not include gain from the sale or other disposition of stock or securities. However, capital gains arising from the sale or other disposition of capital assets, other than stock or securities, shall not be excluded from gross income for this purpose.

(b) The term ''aggregate dividends received'' includes only dividends received from domestic corporations other than dividends described in section 116(b) (relating to dividends not eligible for exclusion from gross income). Accordingly, dividends received from foreign corporations will not be included in the computation of ''aggregate dividends received''. In determining the amount of any dividend for purposes of this section, the rules provided in section 116(c) (relating to certain distributions) shall apply.

§ 1.855–1 Dividends paid by regulated investment company after close of taxable year.

(a) *General rule.* In—

(1) Determining under section 852(a) and paragraph (a) of § 1.852–1 whether the deduction for dividends paid during the taxable year (without regard to capital gain dividends) by a regulated investment company equals or exceeds 90 percent of its investment company taxable income (determined without regard to the provisions of section 852(b)(2)(D)),

(2) Computing its investment company taxable income (under section 852(b)(2) and § 1.852–3), and

(3) Determining the amount of capital gain dividends (as defined in section 852(b)(3) and paragraph (c) of § 1.852–4 paid during the taxable year, any dividend (or portion thereof) declared by the investment company either before or after the close of the taxable year but in any event before the time prescribed by law for the filing of its return for the taxable year (including the period of any extension of time granted for filing such return) shall, to the extent the company so elects in such return, be treated as having been paid during such taxable year. This rule is applicable only if the entire amount of such dividend is actually distributed to the shareholders in the 12-month period following the close of such taxable year and not later than the date of the first regular dividend payment made after such declaration.

(b) *Election*—(1) *Method of making election.* The election must be made in the return filed by the company for the taxable year. The election shall be made by the taxpayer (the regulated investment company) by treating the dividend (or portion thereof) to which such election applies as a dividend paid during the taxable year in computing its investment company taxable income, or if the dividend (or portion thereof) to which such election applies is to be designated by the company as a capital gain dividend, in computing the amount of capital gain dividends paid during such taxable year. The election provided in section 855(a) may be made only to the extent that the earnings and profits of the taxable year (computed with the application of section 852(c) and § 1.852–5) exceed the total amount of distributions out of such earnings and profits actually made during the taxable year (not including distributions with respect to which an election has been made for a prior year under section 855(a)). The dividend or portion thereof, with respect to which the regulated investment company has made a valid election under section 855(a), shall be considered as paid out of the earnings and profits of the taxable year for which such election is made, and not out of the earnings and profits of the taxable year in which the distribution is actually made.

(2) *Irrevocability of the election.* After the expiration of the time for filing the return for the taxable year for which an election is made under section

855(a), such election shall be irrevocable with respect to the dividend or portion thereof to which it applies.

(c) *Receipt by shareholders.* Under section 855(b), the dividend or portion thereof, with respect to which a valid election has been made, will be includible in the gross income of the shareholders of the regulated investment company for the taxable year in which the dividend is received by them.

(d) *Examples.* The application of paragraphs (a), (b), and (c) of this section may be illustrated by the following examples:

Example 1. The X Company, a regulated investment company, had taxable income (and earnings or profits) for the calendar year 1954 of $100,000. During that year the company distributed to shareholders taxable dividends aggregating $88,000. On March 10, 1955, the company declared a dividend of $37,000 payable to shareholders on March 20, 1955. Such dividend consisted of the first regular quarterly dividend for 1955 of $25,000 plus an additional $12,000 representing that part of the taxable income for 1954 which was not distributed in 1954. On March 15, 1955, the X Company filed its federal income tax return and elected therein to treat $12,000 of the total dividend of $37,000 to be paid to shareholders on March 20, 1955, as having been paid during the taxable year 1954. Assuming that the X Company actually distributed the entire amount of the dividend of $37,000 on March 20, 1955, an amount equal to $12,000 thereof will be treated for the purposes of section 852(a) as having been paid during the taxable year 1954. Such amount ($12,000) will be considered by the X Company as a distribution out of the earnings and profits for the taxable year 1954, and will be treated by the shareholders as a taxable dividend for the taxable year in which such distribution is received by them.

Example 2. The Y Company, a regulated investment company, had taxable income (and earnings or profits) for the calendar year 1954 of $100,000, and for 1955 taxable income (and earnings or profits) of $125,000. On January 1, 1954, the company had a deficit in its earnings and profits accumulated since February 28, 1913, of $115,000. During the year 1954 the company distributed to shareholders taxable dividends aggregating $85,000. On March 5, 1955, the company declared a dividend of $65,000 payable to shareholders on March 31, 1955. On March 15, 1955, the Y Company filed its federal income tax return in which it included $40,000 of the total dividend of $65,000 payable to shareholders on March 31, 1955, as a dividend paid by it during the taxable year 1954. On March 31, 1955, the Y Company distributed the entire amount of the dividend of $65,000 declared on March 5, 1955. The election under section 855(a) is valid only to the extent of $15,000, the amount of the undistributed earnings and profits for 1954 ($100,000 earnings and profits less $85,000 distributed during 1954). The remainder ($50,000) of the $65,000 dividend paid on March 31, 1955, could not be the subject of an election, and such amount will be regarded as a distribution by the Y Company out of earnings and profits for the taxable year 1955. Assuming that the only other distribution by the Y Company during 1955 was a distribution of $75,000 paid as a dividend on October 31, 1955, the total amount of the distribution of $65,000 paid on March 31, 1955, is to be treated by the shareholders as taxable dividends for the taxable year in which such dividend is received. The Y Company will treat the amount of $15,000 as a distribution of the earnings or profits of the company for the taxable year 1954, and the remaining $50,000 as a distribution of the earnings or profits for the year 1955. The distribution of $75,000 on October 31, 1955, is, of course, a taxable dividend out of the earnings and profits for the year 1955.

(e) *Notice to shareholders.* Section 855(c) provides that in the case of dividends, with respect to which a regulated investment company has made an election under section 855(a), any notice to shareholders required under subchapter M, chapter 1 of the Code, with respect to such amounts, shall be made not later than 45 days (30 days for a taxable year ending before February 26, 1964) after the close of the taxable year in which the distribution is made. Thus, the notice requirements of section 852(b)(3)(C) and paragraph (c) of § 1.852–4 with respect to capital gain dividends, section 853(c) and § 1.853–3 with respect to allowance to shareholder of foreign tax credit, and section 854(b)(2) and § 1.854–2 with respect to the amount of a distribution which may be treated as a dividend, may be satisfied with respect to amounts to which section 855(a) and this section apply if the notice relating to such amounts is mailed to the shareholders not later than 45 days (30 days for a taxable year ending before February 26, 1964) after the close of the taxable year in which the distribution is made. If the notice under section 855(c) relates to an election with respect to any capital gain dividends, such capital gain dividends shall be aggregated by the investment company with the designated capital gain dividends actually paid during the taxable year to which the

election applies (not including such dividends with respect to which an election has been made for a prior year under section 855) for the purpose of determining whether the aggregate of the designated capital gain dividends with respect to such taxable year of the company is greater than the excess of the net long-term capital gain over the net short-term capital loss of the company. See section 852(b)(3)(C) and paragraph (c) of § 1.852–4.

(f) *Foreign tax election.* Section 855(d) provides that in the case of an election made under section 853 (relating to foreign taxes), the shareholder of the investment company shall consider the foreign income received, and the foreign tax paid, as received and paid, respectively, in the shareholder's taxable year in which distribution is made.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 6921, 32 FR 8757, June 20, 1967]

REAL ESTATE INVESTMENT TRUSTS

§ 1.856–0 Revenue Act of 1978 amendments not included.

The regulations under part II of subchapter M of the Code do not reflect the amendments made by the Revenue Act of 1978, other than the changes made by section 362 of the Act, relating to deficiency dividends.

(Sec. 856(d)(4) (90 Stat. 1750; 26 U.S.C. 856(d)(4)); sec. 856(e)(5) (88 Stat. 2113; 26 U.S.C. 856(e)(5)); sec. 856(f)(2) (90 Stat. 1751; 26 U.S.C. 856(f)(2)); sec. 856 (g)(2) (90 Stat. 1753; 26 U.S.C. 856(g)(2)); sec. 858(a) (74 Stat. 1008; 26 U.S.C. 858(a)); sec. 859(c) (90 Stat. 1743; 26 U.S.C. 859(c)); sec. 859(e) (90 Stat. 1744; 26 U.S.C. 859(e)); sec. 6001 (68A Stat. 731; 26 U.S.C. 6001); sec. 6011 (68A Stat. 732; 26 U.S.C. 6011); sec. 6071 (68A Stat. 749, 26 U.S.C. 6071); sec. 6091 (68A Stat. 752; 26 U.S.C. 6091); sec. 7805 (68A Stat. 917; 26 U.S.C. 7805), Internal Revenue Code of 1954; 860(e) (92 Stat. 2849, 26 U.S.C. 860(e)); sec. 860(g) (92 Stat. 2850, 26 U.S.C. 860(g)))

[T.D. 7767, 46 FR 11265, Feb. 6, 1981, as amended by T.D. 7936, 49 FR 2106, Jan. 18, 1984]

§ 1.856–1 Definition of real estate investment trust.

(a) *In general.* The term ''real estate investment trust'' means a corporation, trust, or association which (1) meets the status conditions in section 856(a) and paragraph (b) of this section, and (2) satisfies the gross income and asset diversification requirements under the limitations of section 856(c) and § 1.856–2. (See, however, paragraph (f) of this section, relating to the requirement that, for taxable years beginning before October 5, 1976, a real estate investment trust must be an unincorporated trust or unincorporated association).

(b) *Qualifying conditions.* To qualify as a ''real estate investment trust'', an organization must be one—

(1) Which is managed by one or more trustees or directors,

(2) The beneficial ownership of which is evidenced by transferable shares or by transferable certificates of beneficial interest,

(3) Which would be taxable as a domestic corporation but for the provisions of part II, subchapter M, chapter 1 of the Code,

(4) Which, in the case of a taxable year beginning before October 5, 1976, does not hold any property (other than foreclosure property) primarily for sale to customers in the ordinary course of its trade or business,

(5) Which is neither (i) a financial institution to which section 585, 586, or 593 applies, nor (ii) an insurance company to which subchapter L applies,

(6) The beneficial ownership of which is held by 100 or more persons, and

(7) Which would not be a personal holding company (as defined in section 542) if all of its gross income constituted personal holding company income (as defined in section 543).

(c) *Determination of status.* The conditions described in subparagraphs (1) through (5) of paragraph (b) of this section must be met during the entire taxable year and the condition described in subparagraph (6) of paragraph (b) of this section must exist during at least 335 days of a taxable year of 12 months or during a proportionate part of a taxable year of less than 12 months. The days during which the latter condition must exist need not be consecutive. In determining the minimum number of days during which the condition described in paragraph (b)(6) of this section is required to exist in a taxable year of less than 12 months, fractional days shall be disregarded. For example, in a taxable year of 310 days, the actual

number of days prescribed would be 284 38/73 days (310/365 of 335). The fractional day is disregarded so that the required condition in such taxable year need exist for only 284 days.

(d) *Rules applicable to status requirements.* For purposes of determining whether an organization meets the conditions and requirements in section 856(a), the following rules shall apply.

(1) *Trustee.* The term ''trustee'' means a person who holds legal title to the property of the real estate investment trust, and has such rights and powers as will meet the requirement of ''centralization of management'' under paragraph (c) of §301.7701–2 of this chapter (Regulations on Procedure and Administration). Thus, the trustee must have continuing exclusive authority over the management of the trust, the conduct of its affairs, and (except as limited by section 856(d)(3) and §1.856–4) the management and disposition of the trust property. For example, such authority will be considered to exist even though the trust instrument grants to the shareholders any or all of the following rights and powers: To elect or remove trustees; to terminate the trust; and to ratify amendments to the trust instrument proposed by the trustee. The existence of a mere fiduciary relationship does not, in itself, make one a trustee for purposes of section 856(a)(1). The trustee will be considered to hold legal title to the property of the trust, for purposes of this subparagraph, whether the title is held in the name of the trust itself, in the name of one or more of the trustees, or in the name of a nominee for the exclusive benefit of the trust.

(2) *Beneficial ownership.* Beneficial ownership shall be evidenced by transferable shares, or by transferable certificates of beneficial interest, and (subject to the provisions of paragraph (c) of this section) must be held by 100 or more persons, determined without reference to any rules of attribution. Provisions in the trust instrument or corporate charter or bylaws which permit the trustee or directors to redeem shares or to refuse to transfer shares in any case where the trustee or directors, in good faith, believe that a failure to redeem shares or that a transfer of shares would result in the loss of status as a real estate investment trust will not render the shares ''nontransferable.'' For purposes of the regulations under part II of subchapter M, the terms ''stockholder,'' ''stockholders,'' ''shareholder,'' and ''shareholders'' include holders of beneficial interest in a real estate investment trust, the terms ''stock,'' ''shares,'' and ''shares of stock'' include certificates of beneficial interest, and the term ''shares'' includes shares of stock.

(3) *Unincorporated organization taxable as a domestic corporation.* The determination of whether an unincorporated organization would be taxable as a domestic corporation, in the absence of the provisions of part II of subchapter M, shall be made in accordance with the provisions of section 7701(a) (3) and (4) and the regulations thereunder and for such purposes an otherwise qualified real estate investment trust is deemed to satisfy the ''objective to carry on business'' requirement of paragraph (a) of §301.7701–2 of this chapter. (Regulations on Procedure and Administration).

(4) *Property held for sale to customers.* In the case of a taxable year beginning before October 5, 1976, a real estate investment trust may not hold any property (other than foreclosure property) primarily for sale to customers in the ordinary course of its trade or business. Whether property is held for sale to customers in the ordinary course of the trade or business of a real estate investment trust depends upon the facts and circumstances in each case.

(5) *Personal holding company.* A corporation, trust, or association, even though it may otherwise meet the requirements of part II of subchapter M, will not be a real estate investment trust if, by considering all of its gross income as personal holding company income under section 543, it would be a personal holding company as defined in section 542. Thus, if at any time during the last half of the trust's taxable year more than 50 percent in value of its outstanding stock is owned (directly or indirectly under the provisions of section 544) by or for not more than 5 individuals, the stock ownership requirement in section 542(a)(2) will be met

and the trust would be a personal holding company. See § 1.857–8, relating to record requirements for purposes of determining whether the trust is a personal holding company.

(e) *Other rules applicable.* To the extent that other provisions of chapter 1 of the Code are not inconsistent with those under part II of subchapter M there of and the regulations thereunder, such provisions will apply with respect to both the real estate investment trust and its shareholders in the same manner that they would apply to any other organization which would be taxable as a domestic corporation. For example:

(1) Taxable income of a real estate investment trust is computed in the same manner as that of a domestic corporation;

(2) Section 301, relating to distributions of property, applies to distributions by a real estate investment trust in the same manner as it would apply to a domestic corporation;

(3) Sections 302, 303, 304, and 331 are applicable in determining whether distributions by a real estate investment trust are to be treated as in exchange for stock;

(4) Section 305 applies to distributions by a real estate investment trust of its own stock;

(5) Section 311 applies to distributions by a real estate investment trust;

(6) Except as provided in section 857(d), earnings and profits of a real estate investment trust are computed in the same manner as in the case of a domestic corporation;

(7) Section 316, relating to the definition of a dividend, applies to distributions by a real estate investment trust; and

(8) Section 341, relating to collapsible corporations, applies to gain on the sale or exchange of, or a distribution which is in exchange for, stock in a real estate investment trust in the same manner that it would apply to a domestic corporation.

(f) *Unincorporated status required for certain taxable years.* In the case of a taxable year beginning before October 5, 1976, a real estate investment trust must be an unincorporated trust or unincorporated association. Accordingly, in applying the regulations under part II of subchapter M of the Code with respect to such a taxable year, the term ''an unincorporated trust or unincorporated association'' is to be substituted for the term ''a corporation, trust, or association'' each place it appears, and the references to ''directors'' and ''corporate charter or bylaws'' are to be disregarded.

(Sec. 856(d)(4) (90 Stat. 1750; 26 U.S.C. 856(d)(4)); sec. 856(e)(5) (88 Stat. 2113; 26 U.S.C. 856(e)(5)); sec. 856(f)(2) (90 Stat. 1751; 26 U.S.C. 856(f)(2)); sec. 856(g)(2) (90 Stat. 1753; 26 U.S.C. 856(g)(2)); sec. 858(a) (74 Stat. 1008; 26 U.S.C. 858(a)); sec. 859(c) (90 Stat. 1743; 26 U.S.C. 859(c)); sec. 859(e) (90 Stat. 1744; 26 U.S.C. 859(e)); sec. 6001 (68A Stat. 731; 26 U.S.C. 6001); sec. 6011 (68A Stat. 732; 26 U.S.C. 6011); sec. 6071 (68A Stat. 749, 26 U.S.C. 6071); sec. 6091 (68A Stat. 752; 26 U.S.C. 6091); sec. 7805 (68A Stat. 917, 26 U.S.C. 7805), Internal Revenue Code of 1954)

[T.D. 6598, 27 FR 4082, Apr. 28, 1962, as amended by T.D. 6928, 32 FR 13221, Sept. 19, 1967; T.D. 7767, 46 FR 11265, Feb. 6, 1981]

§ 1.856–2 Limitations.

(a) *Effective date.* The provisions of part II, subchapter M, chapter 1 of the Code, and the regulations thereunder apply only to taxable years of a real estate investment trust beginning after December 31, 1960.

(b) *Election.* Under the provisions of section 856(c)(1), a trust, even though it satisfies the other requirements of part II of subchapter M for the taxable year, will not be considered a ''real estate investment trust'' for such year, within the meaning of such part II, unless it elects to be a real estate investment trust for such taxable year, or has made such an election for a previous taxable year which has not been terminated or revoked under section 856(g)(1) or (2). The election shall be made by the trust by computing taxable income as a real estate investment trust in its return for the first taxable year for which it desires the election to apply, even though it may have otherwise qualified as a real estate investment trust for a prior year. No other method of making such election is permitted. An election cannot be revoked with respect to a taxable year beginning before October 5, 1976. Thus, the failure of an organization to be a qualified real estate investment trust for a taxable year beginning before October 5, 1976,

does not have the effect of revoking a prior election by the organization to be a real estate investment trust, even though the organization is not taxable under part II of subchapter M for such taxable year. See section 856(g) and §1.856–8 for rules under which an election may be revoked with respect to taxable years beginning after October 4, 1976.

(c) *Gross income requirements.* Section 856(c) (2), (3), and (4), provides that a corporation, trust, or association is not a ''real estate investment trust'' for a taxable year unless it meets certain requirements with respect to the sources of its gross income for the taxable year. In determining whether the gross income of a real estate investment trust satisfies the percentage requirements of section 856(c) (2), (3), and (4), the following rules shall apply:

(1) *Gross income.* For purposes of both the numerator and denominator in the computation of the specified percentages, the term ''gross income'' has the same meaning as that term has under section 61 and the regulations thereunder. Thus, in determining the gross income requirements under section 856(c) (2), (3), and (4), a loss from the sale or other disposition of stock, securities, real property, etc. does not enter into the computation.

(2) *Lapse of options.* Under section 856(c)(6)(C), the term ''interests in real property'' includes options to acquire land or improvements thereon, and options to acquire leaseholds of land and improvements thereon. However, where a corporation, trust, or association writes an option giving the holder the right to acquire land or improvements thereon, or writes an option giving the holder the right to acquire a leasehold of land or improvements thereon, any income that the corporation, trust, or association recognizes because the option expires unexercised is not considered to be gain from the sale or other disposition of real property (including interests in real property) for purposes of section 856(c) (2)(D) and (3)(C). The rule in the preceding sentence also applies for purposes of section 856(c)(4)(C) in determining gain from the sale or other disposition of real property for the 30-percent-of-gross-income limitation.

(3) *Commitment fees.* For purposes of section 856(c) (2)(G) and (3)(G), if consideration is received or accrued for an agreement to make a loan secured by a mortgage covering both real property and other property, or for an agreement to purchase or lease both real property and other property, an apportionment of the consideration is required. The apportionment of consideration received or accrued for an agreement to make a loan secured by a mortgage covering both real property and other property shall be made under the principles of §1.856–5(c), relating to the apportionment of interest income.

(4) *Holding period of property.* For purposes of the 30-percent limitation of section 856(c)(4), the determination of the period for which property described in such section has been held is governed by the provisions of section 1223 and the regulations thereunder.

(5) *Rents from real property and interest.* See §§1.856–4 and 1.856–5 for rules relating to rents from real property and interest.

(d) *Diversification of investment requirements*—(1) *75-percent test.* Section 856(c)(5)(A) requires that at the close of each quarter of the taxable year at least 75 percent of the value of the total assets of the trust be represented by one or more of the following:

(i) Real estate assets;

(ii) Government securities; and

(iii) Cash and cash items (including receivables).

For purposes of this subparagraph the term ''receivables'' means only those receivables which arise in the ordinary course of the trust's operation and does not include receivables purchased from another person. Subject to the limitations in section 856(c)(5)(B) and subparagraph (2) of this paragraph, the character of the remaining 25 percent (or less) of the value of the total assets is not restricted.

(2) *Limitations on certain securities.* Under section 856(c)(5)(B), not more than 25 percent of the value of the total assets of the trust may be represented by securities other than those described in section 856(c)(5)(A). The ownership of securities under the 25-percent limitation in section 856(c)(5)(B) is further limited in respect of any one issuer to an amount not

greater in value than 5 percent of the value of the total assets of the trust and to not more than 10 percent of the outstanding voting securities of such issuer. Thus, if the real estate investment trust meets the 75-percent asset diversification requirement in section 856(c)(5)(A), it will also meet the first test under section 856(c)(5)(B) since it will, of necessity, have not more than 25 percent of its total assets represented by securities other than those described in section 856(c)(5)(A). However, the trust must also meet two additional tests under section 856(c)(5)(B), i.e. it cannot own the securities of any one issuer in an amount (i) greater in value than 5 percent of the value of the trust's total assets, or (ii) representing more than 10 percent of the outstanding voting securities of such issuer.

(3) *Determination of investment status.* The term ''total assets'' means the gross assets of the trust determined in accordance with generally accepted accounting principles. In order to determine the effect, if any, which an acquisition of any security or other property may have with respect to the status of a trust as a real estate investment trust, section 856(c)(5) requires a revaluation of the trust's assets at the end of the quarter in which such acquisition was made. A revaluation of assets is not required at the end of any quarter during which there has been no acquisition of a security or other property since the mere change in market value of property held by the trust does not, of itself, affect the status of the trust as a real estate investment trust. A change in the nature of ''cash items'', for example, the prepayment of insurance or taxes, does not constitute the acquisition of ''other property'' for purposes of this subparagraph. A real estate investment trust shall keep sufficient records as to investments so as to be able to show that it has complied with the provisions of section 856(c)(5) during the taxable year. Such records shall be kept at all times available for inspection by any internal revenue officer or employee and shall be retained so long as the contents thereof may become material in the administration of any internal revenue law.

(4) *Illustrations.* The application of section 856(c)(5) and this paragraph may be illustrated by the following examples:

Example 1. Real Estate Investment Trust M, at the close of the first quarter of its taxable year, has its assets invested as follows:

	Percent
Cash	6
Government securities	7
Real estate assets	63
Securities of various corporations (not exceeding, with respect to any one issuer, 5 percent of the value of the total assets of the trust nor 10 percent of the outstanding voting securities of such issuer)	24
Total	100

Trust M meets the requirements of section 856(c)(5) for that quarter of its taxable year.

Example 2. Real Estate Investment Trust P, at the close of the first quarter of its taxable year, has its assets invested as follows:

	Percent
Cash	6
Government securities	7
Real estate assets	63
Securities of Corporation Z	20
Securities of Corporation X	4
Total	100

Trust P meets the requirement of section 856(c)(5)(A) since at least 75 percent of the value of the total assets is represented by cash, Government securities, and real estate assets. However, Trust P does not meet the diversification requirements of section 856(c)(5)(B) because its investment in the voting securities of Corporation Z exceeds 5 percent of the value of the trust's total assets.

Example 3. Real Estate Investment Trust G, at the close of the first quarter of its taxable year, has its assets invested as follows:

	Percent
Cash	4
Government securities	9
Real estate assets	70
Securities of Corporation S	5
Securities of Corporation L	4
Securities of Corporation U	4
Securities of Corporation M (which equals 25 percent of Corporation M's outstanding voting securities)	4
Total	100

Trust G meets the 75-percent requirement of section 856(c)(5)(A), but does not meet the requirements of section 856(c)(5)(B) because its investment in the voting securities of Corporation M exceeds 10 percent of Corporation M's outstanding voting securities.

Example 4. Real Estate Investment Trust R, at the close of the first quarter of its taxable year (i.e. calendar year), is a qualified real estate investment trust and has its assets invested as follows:

Cash	$5,000
Government securities	4,000
Receivables	4,000
Real estate assets	68,000
Securities of Corporation P	4,000
Securities of Corporation O	5,000
Securities of Corporation U	5,000
Securities of Corporation T	5,000
Total assets	100,000

During the second calendar quarter the stock in Corporation P increases in value to $50,000 while the value of the remaining assets has not changed. If Real Estate Investment Trust R has made no acquisition of stock or other property during such second quarter it will not lose its status as a real estate investment trust merely by reason of the appreciation in the value of P's stock. If, during the third quarter, Trust R acquires stock of Corporation S worth $2,000, such acquisition will necessitate a revaluation of all of the assets of Trust R as follows:

Cash	$3,000
Government securities	4,000
Receivables	4,000
Real estate assets	68,000
Securities in Corporation P	50,000
Securities in Corporation O	5,000
Securities in Corporation U	5,000
Securities in Corporation T	5,000
Securities in Corporation S	2,000
Total assets	146,000

Because of the discrepancy between the value of its various investments and the 25-percent limitation in section 856(c)(5), resulting in part from the acquisition of the stock of Corporation S, Trust R, at the end of the third quarter, loses its status as a real estate investment trust. However, if Trust R, within 30 days after the close of such quarter, eliminates the discrepancy so that it meets the 25-percent limitation, the trust will be considered to have met the requirements of section 856(c)(5) at the close of the third quarter, even though the discrepancy between the value of its investment in Corporation P and the 5-percent limitation in section 856(c)(5) (resulting solely from appreciation) may still exist. If instead of acquiring stock of Corporation S, Trust R had acquired additional stock of Corporation P, then because of the discrepancy between the value of its investments and both the 5-percent and the 25-percent limitations in section 856(c)(5) resulting in part from this acquisition, trust R, at the end of the third quarter, would lose its status as a real estate investment trust, unless within 30 days after the close of such quarter both of the discrepancies are eliminated.

Example 5. If, in the previous example, the stock of Corporation P appreciates only to $10,000 during the second quarter and, in the third quarter, Trust R acquires stock of Corporation S worth $1,000, the assets as of the end of the third quarter would be as follows:

Cash	$4,000
Government securities	4,000
Receivables	4,000
Real estate assets	68,000
Securities in Corporation P	10,000
Securities in Corporation O	5,000
Securities in Corporation U	5,000
Securities in Corporation T	5,000
Securities in Corporation S	1,000
Total assets	106,000

Because the discrepancy between the value of its investment in Corporation P and the 6-percent limitation in section 856(c)(5) results solely from appreciation, and because there is no discrepancy between the value of its various investments and the 25-percent limitation, Trust R, at the end of the third quarter, does not lose its status as a real estate investment trust. If, instead of acquiring stock of Corporation S, Trust R had acquired additional stock of Corporation P worth $1,000, then, because of the discrepancy between the value of its investment in Corporation P and the 5-percent limitation resulting in part from this acquisition, Trust R, at the end of the third quarter, would lose its status as a real estate investment trust, unless within 30 days after the close of such quarter this discrepancy is eliminated.

(Sec. 856(d)(4) (90 Stat. 1750; 26 U.S.C. 856(d)(4)); sec. 856(e)(5) (88 Stat. 2113; 26 U.S.C. 856(e)(5)); sec. 856(f)(2) (90 Stat. 1751; 26 U.S.C. 856(f)(2)); sec. 856(g)(2) (90 Stat. 1753; 26 U.S.C. 856(g)(2)); sec. 858(a) (74 Stat. 1008; 26 U.S.C. 858(a)); sec. 859(c) (90 Stat. 1743; 26 U.S.C. 859(c)); sec. 859(e) (90 Stat. 1744; 26 U.S.C. 859(e)); sec. 6001); (68A Stat. 731; 26 U.S.C. 6001); sec. 6011 (68A Stat. 732; 26 U.S.C. 6011); sec. 6071 (68A Stat. 749, 26 U.S.C. 6071); sec. 6091 (68A Stat. 752; 26 U.S.C. 6091); sec. 7805 (68A Stat. 917; 26 U.S.C. 7805), Internal Revenue Code of 1954)

[T.D. 6598, 27 FR 4083, Apr. 28, 1962, as amended by T.D. 7767, 46 FR 11265, Feb. 6, 1981]

§ 1.856–3 Definitions.

For purposes of the regulations under part II, subchapter M, chapter 1 of the Code, the following definitions shall apply.

(a) *Value.* The term ''value'' means, with respect to securities for which market quotations are readily available, the market value of such securities; and with respect to other securities and assets, fair value as determined in good faith by the trustees of

the real estate investment trust. In the case of securities of other qualified real estate investment trusts, fair value shall not exceed market value or asset value, whichever is higher.

(b) *Real estate assets*—(1) *In general.* The term ''real estate assets'' means real property, interests in mortgages on real property (including interests in mortgages on leaseholds of land or improvements thereon), and shares in other qualified real estate investment trusts. The term ''mortgages on real property'' includes deeds of trust on real property.

(2) *Treatment of REMIC interests as real estate assets*—(i) *In general.* If, for any calendar quarter, at least 95 percent of a REMIC's assets (as determined in accordance with §1.860F–4(e)(1)(ii) or §1.6049–7(f)(3)) are real estate assets (as defined in paragraph (b)(1) of this section), then, for that calendar quarter, all the regular and residual interests in that REMIC are treated as real estate assets and, except as provided in paragraph (b)(2)(iii) of this section, any amount includible in gross income with respect to those interests is treated as interest on obligations secured by mortgages on real property. If less than 95 percent of a REMIC's assets are real estate assets, then the real estate investment trust is treated as holding directly its proportionate share of the assets and as receiving directly its proportionate share of the income of the REMIC. See §§1.860F–4(e)(1)(ii)(B) and 1.6049–7(f)(3) for information required to be provided to regular and residual interest holders if the 95-percent test is not met.

(ii) *Treatment of REMIC assets for section 856 purposes*—(A) *Manufactured housing treated as real estate asset.* For purposes of paragraphs (b) (1) and (2) of this section, the term ''real estate asset'' includes manufactured housing treated as a single family residence under section 25(e)(10).

(B) *Status of cash flow investments.* For purposes of this paragraph (b)(2), cash flow investments (as defined in section 860G(a)(6) and §1.860G–2(g)(1)) are real estate assets.

(iii) *Certain contingent interest payment obligations held by a REIT.* If a REIT holds a residual interest in a REMIC for a principal purpose of avoiding the limitation set out in section 856(f) (concerning interest based on mortgagor net profits) or section 856(j) (concerning shared appreciation provisions), then, even if the REMIC satisfies the 95-percent test of paragraph (b)(i) of this section, the REIT is treated as receiving directly the REMIC's items of income for purposes of section 856.

(c) *Interests in real property.* The term ''interests in real property'' includes fee ownership and co-ownership of land or improvements thereon, leaseholds of land or improvements thereon, options to acquire land or improvements thereon, and options to acquire leaseholds of land or improvements thereon. The term also includes timeshare interests that represent an undivided fractional fee interest, or undivided leasehold interest, in real property, and that entitle the holders of the interests to the use and enjoyment of the property for a specified period of time each year. The term also includes stock held by a person as a tenant-stockholder in a cooperative housing corporation (as those terms are defined in section 216). Such term does not, however, include mineral, oil, or gas royalty interests, such as a retained economic interest in coal or iron ore with respect to which the special provisions of section 631(c) apply.

(d) *Real property.* The term ''real property'' means land or improvements thereon, such as buildings or other inherently permanent structures thereon (including items which are structural components of such buildings or structures). In addition, the term ''real property'' includes interests in real property. Local law definitions will not be controlling for purposes of determining the meaning of the term ''real property'' as used in section 856 and the regulations thereunder. The term includes, for example, the wiring in a building, plumbing systems, central heating, or central air-conditioning machinery, pipes or ducts, elevators or escalators installed in the building, or other items which are structural components of a building or other permanent structure. The term does not include assets accessory to the operation of a business, such as machinery, printing press, transportation equipment

which is not a structural component of the building, office equipment, refrigerators, individual air-conditioning units, grocery counters, furnishings of a motel, hotel, or office building, etc., even though such items may be termed fixtures under local law.

(e) *Securities.* The term ''securities'' does not include ''interests in real property'' or ''real estate assets'' as those terms are defined in section 856 and this section.

(f) *Qualified real estate investment trusts.* The term ''qualified real estate investment trust'' means a real estate investment trust within the meaning of part II of subchapter M which is taxable under such part as a real estate investment trust. For purposes of the 75-percent requirement in section 856(c)(5)(A), the trust whose stock has been included by another trust as ''real estate assets'' must be a ''qualified real estate investment trust'' for its full taxable year in which falls the close of each quarter of the trust's taxable year for which the computation is made. For example, Real Estate Investment Trust Z for its taxable year ending December 31, 1963, holds as ''real estate assets'' stock in Real Estate Investment Trust Y, which is also on a calendar year. If Trust Y is not a qualified real estate investment trust for its full taxable year ending December 31, 1963, Trust Z may not include the stock of Trust Y as ''real estate assets'' in computing the 75-percent requirement as of the close of any quarter of its taxable year ending December 31, 1963.

(g) *Partnership interest.* In the case of a real estate investment trust which is a partner in a partnership, as defined in section 7701(a)(2) and the regulations thereunder, the trust will be deemed to own its proportionate share of each of the assets of the partnership and will be deemed to be entitled to the income of the partnership attributable to such share. For purposes of section 856, the interest of a partner in the partnership's assets shall be determined in accordance with his capital interest in the partnership. The character of the various assets in the hands of the partnerhsip and items of gross income of the partnership shall retain the same character in the hands of the partners for all purposes of section 856. Thus, for example, if the trust owns a 30-percent capital interest in a partnership which owns a piece of rental property the trust will be treated as owning 30 percent of such property and as being entitled to 30 percent of the rent derived from the property by the partnership. Similarly, if the partnership holds any property primarily for sale to customers in the ordinary course of its trade or business, the trust will be treated as holding its proportionate share of such property primarily for such purpose. Also, for example, where a partnership sells real property or a trust sells its interest in a partnership which owns real property, any gross income realized from such sale, to the extent that it is attributable to the real property, shall be deemed gross income from the sale or disposition of real property held for either the period that the partnership has held the real property of the period that the trust was a member of the partnership, whichever is the shorter.

(h) *Net capital gain.* The term ''net capital gain'' means the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for the taxable year.

(Sec. 856(d)(4) (90 Stat. 1750; 26 U.S.C. 856(d)(4)); sec. 856(e)(5) (88 Stat. 2113; 26 U.S.C. 856(e)(5)); sec. 856(f)(2) (90 Stat. 1751; 26 U.S.C. 856(f)(2)); sec. 856(g)(2) (90 Stat. 1753; 26 U.S.C. 856(g)(2)); sec. 858(a) (74 Stat. 1008; 26 U.S.C. 858(a)); sec. 859(c) (90 Stat. 1743; 26 U.S.C. 859(c)); sec. 859(e) (90 Stat. 1744; 26 U.S.C. 859(e)); sec. 6001 (68A Stat. 731; 26 U.S.C. 6001); sec. 6011 (68A Stat. 732; 26 U.S.C. 6011); sec. 6071 (68A Stat. 749, 26 U.S.C. 6071); sec. 6091 (68A Stat. 752; 26 U.S.C. 6091); sec. 7805 (68A Stat. 917; 26 U.S.C. 7805), Internal Revenue Code of 1954)

[T.D. 6598, 27 FR 4084, Apr. 28, 1962, as amended by T.D. 6841, 30 FR 9308, July 27, 1965; T.D. 7767, 46 FR 11266, Feb. 6, 1981; T.D. 8458, 57 FR 61298, Dec. 24, 1992]

§ 1.856–4 Rents from real property.

(a) *In general.* Subject to the exceptions of section 856(d) and paragraph (b) of this section, the term ''rents from real property'' means, generally, the gross amounts received for the use of, or the right to use, real property of the real estate investment trust.

(b) *Amounts specifically included or excluded*—(1) *Charges for customary services.* For taxable years beginning after

October 4, 1976, the term ''rents from real property'', for purposes of paragraphs (2) and (3) of section 856(c), includes charges for services customarily furnished or rendered in connection with the rental of real property, whether or not the charges are separately stated. Services furnished to the tenants of a particular building will be considered as customary if, in the geographic market in which the building is located, tenants in buildings which are of a similar class (such as luxury apartment buildings) are customarily provided with the service. The furnishing of water, heat, light, and air-conditioning, the cleaning of windows, public entrances, exits, and lobbies, the performance of general maintenance and of janitorial and cleaning services, the collection of trash, and the furnishing of elevator services, telephone answering services, incidental storage space, laundry equipment, watchman or guard services, parking facilities, and swimming pool facilities are examples of services which are customarily furnished to the tenants of a particular class of buildings in many geographic marketing areas. Where it is customary, in a particular geographic marketing area, to furnish electricity or other utilities to tenants in buildings of a particular class, the submetering of such utilities to tenants in such buildings will be considered a customary service. To qualify as a service customarily furnished, the service must be furnished or rendered to the tenants of the real estate investment trust or, primarily for the convenience or benefit of the tenant, to the guests, customers, or subtenants of the tenant. The service must be furnished through an independent contractor from whom the trust does not derive or receive any income. See paragraph (b)(5) of this section. For taxable years beginning before October 5, 1976, the rules in paragraph (b)(3) of 26 CFR 1.856–4 (revised as of April 1, 1977), relating to the furnishing of services, shall continue to apply.

(2) *Amounts received with respect to certain personal property*—(i) *In general.* In the case of taxable years beginning after October 4, 1976, rent attributable to personal property that is leased under, or in connection with, the lease of real property is treated under section 856(d)(1)(C) as ''rents from real property'' (and thus qualified for purposes of the income source requirements) if the rent attributable to the personal property is not more than 15 percent of the total rent received or accrued under the lease for the taxable year. If, however, the rent attributable to personal property is greater than 15 percent of the total rent received or accrued under the lease for the taxable year, then the portion of the rent from the lease that is attributable to personal property will not qualify as ''rents from real property''.

(ii) *Application.* In general, the 15-percent test in section 856(d)(1)(C) is applied separately to each lease of real property. However, where the real estate investment trust rents all (or a portion of all) the units in a multiple unit project under substantially similar leases (such as the leasing of apartments in an apartment building or complex to individual tenants), the 15-percent test may be applied with respect to the aggregate rent received or accrued for the taxable year under the similar leases of the property, by using the average of the trust's aggregate adjusted bases of all of the personal property subject to such leases, and the average of the trust's aggregate adjusted bases of all real and personal property subject to such leases. A lease of a furnished apartment is not considered to be substantially similar to a lease of an unfurnished apartment (including an apartment where the trust provides only personal property, such as major appliances, that is commonly provided by a landlord in connection with the rental of unfurnished living quarters).

(iii) *Taxable years beginning before October 5, 1976.* In the case of taxable years beginning before October 5, 1976, any amount of rent that is attributable to personal property does not qualify as rent from real property.

(3) *Disqualification of rent which depends on income or profits of any person.* Except as provided in paragraph (b)(6)(ii) of this section, no amount received or accrued, directly or indirectly, with respect to any real property (or personal property leased

under, or in connection with, real property) qualifies as ''rents from real property'' where the determination of the amount depends in whole or in part on the income or profits derived by any person from the property. However, any amount so accured or received shall not be excluded from the term ''rents from real property'' solely by reason of being based on a fixed percentage or percentages of receipts or sales (whether or not receipts or sales are adjusted for returned merchandise, or Federal, State, or local sales taxes). Thus, for example, ''rents from real property'' would include rents where the lease provides for differing percentages or receipts or sales from different departments or from separate floors of a retail store so long as each percentage is fixed at the time of entering into the lease and a change in such percentage is not renegotiated during the term of the lease (including any renewal periods of the lease, in a manner which has the effect of basing the rent on income of profits. See paragraph (b)(6) of this section for rules relating to certain amounts received or accrued by a trust which are considered to be based on the income or profits of a sublessee of the prime tenant. The amount received or accrued as rent for the taxable year which is based on a fixed percentage or percentages of the lessee's receipts or sales reduced by escalation receipts (including those determined under a formula clause) will qualify as ''rents from real property''. Escalation receipts include amounts received by a prime tenant from subtenants by reason of an agreement that rent shall be increased to reflect all or a portion of an increase in real estate taxes, property insurance, operating costs of the prime tenant, or similar items customarily included in lease escalation clauses. Where in accordance with the terms of an agreement an amount received or accrued as rent for the taxable year includes both a fixed rental and a percentage of all or a portion of the lessee's income or profits, neither the fixed rental nor the additional amount will qualify as ''rents from real property''. However, where the amount received or accrued for the taxable year under such an agreement includes only the fixed rental, the determination of which does not depend in whole or in part on the income or profits derived by the lessee, such amount may qualify as ''rents from real property''. An amount received or accrued as rent for the taxable year which consists, in whole or in part, of one or more percentages of the lessee's receipts or sales in excess of determinable dollar amounts may qualify as ''rents from real property'', but only if two conditions exist. First, the determinable amounts must not depend in whole or in part on the income or profits of the lessee. Second, the percentages and, in the case of leases entered into after July 7, 1978, the determinable amounts, must be fixed at the time the lease is entered into and a change in percentages and determinable amounts is not renegotiated during the term of the lease (including any renewal periods of the lease) in a manner which has the effect of basing rent on income or profits. In any event, an amount will not qualify as ''rents from real property'' if, considering the lease and all the surrounding circumstances, the arrangement does not conform with normal business practice but is in reality used as a means of basing the rent on income or profits. The provisions of this subparagraph may be illustrated by the following example:

Example. A real estate investment trust owns land underlying an office building. On January 1, 1975, the trust leases the land for 50 years to a prime tenant for an annual rental of $100x plus 20 percent of the prime tenant's annual gross receipts from the office building in excess of a fixed base amount of $5,000x and 10 percent of such gross receipts in excess of $10,000x. For this purpose the lease defines gross receipts as all amounts received by the prime tenant from occupancy tenants pursuant to leases of space in the office building reduced by the amount by which real estate taxes, property insurance, and operating costs related to the office building for a particular year exceed the amount of such items for 1974. The exclusion from gross receipts of increases since 1974 in real estate taxes, property insurance, and other expenses relating to the office building reflects the fact that the prime tenant passes on to occupancy tenants by way of a customary lease escalation provision the risk that such expenses might increase during the term of an occupancy lease. The exclusion from gross receipts of these expense escalation items will not cause the rental received by the real estate investment trust

from the prime tenant to fail to qualify as ''rents from real property'' for purposes of section 856(c).

(4) *Disqualification of amounts received from persons owned in whole or in part by the trust.* ''Rents from real property'' does not include any amount received or accrued, directly or indirectly, from any person in which the real estate investment trust owns, at any time during the taxable year, the specified percentage or number of shares of stock (or interest in the assets or net profits) of that person. Any amount received from such person will not qualify as ''rents from real property'' if such person is a corporation and the trust owns 10 percent or more of the total combined voting power of all classes of its stock entitled to vote or 10 percent or more of the total number of shares of all classes of its outstanding stock, or if such person is not a corporation and the trust owns a 10-percent-or-more interest in its assets or net profits. For example, a trust leases an office building to a tenant for which it receives rent of $100,000 for the taxable year 1962. The lessee of the building subleases space to various subtenants for which it receives gross rent of $500,000 for the year 1962. The trust owns 15 percent of the total assets of an unincorporated subtenant. The rent paid by this subtenant for the taxable year is $50,000. Therefore, $10,000 (50,000/500,000 × $100,000) of the rent paid to the trust does not qualify as ''rents from real property''. Where the real estate investment trust receives, directly or indirectly, any amount of rent from any person in which it owns any proprietary interest, the trust shall submit, at the time it files its return for the taxable year (or before June 1, 1962, whichever is later), a schedule setting forth—

(i) The name and address of such person and the amount received as rent from such person; and

(ii) If such person is a corporation, the highest percentage of the total combined voting power of all classes of its stock entitled to vote, and the highest percentage of the total number of shares of all classes of its outstanding stock, owned by the trust at any time during the trust's taxable year; or

(iii) If such person is not a corporation, the highest percentage of the trust's interest in the assets or net profits of such person, owned by the trust at any time during its taxable year.

(5) *Furnishing of services or management of property must be through an independent contractor*—(i) *In general.* No amount received or accrued, directly or indirectly, with respect to any real property (or any personal property leased under, or in connection with, the real property) qualifies as ''rents from real property'' if the real estate investment trust furnishes or renders services to the tenants of the property or manages or operates the property, other than through an independent contractor from whom the trust itself does not derive or receive any income. The prohibition against the trust deriving or receiving any income from the independent contractor applies regardless of the source from which the income was derived by the independent contractor. Thus, for example, the trust may not receive any dividends from the independent contractor. The requirement that the trust not receive any income from an independent contractor requires that the relationship between the two be an arm's-length relationship. The independent contractor must be adequately compensated for any services which are performed for the trust. Compensation to an independent contractor determined by reference to an unadjusted percentage of gross rents will generally be considered to be adequate where the percentage is reasonable taking into account the going rate of compensation for managing similar property in the same locality, the services rendered, and other relevant factors. The independent contractor must not be an employee of the trust (*i.e.*, the manner in which he carries out his duties as independent contractor must not be subject to the control of the trust). Although the cost of services which are customarily rendered or furnished in connection with the rental of real property may be borne by the trust, the services must be furnished or rendered through an independent contractor. Furthermore, the facilities through which the

services are furnished must be maintained and operated by an independent contractor. For example, if a heating plant is located in the building, it must be maintained and operated by an independent contractor. To the extent that services (other than those customarily furnished or rendered in connection with the rental of real property) are rendered to the tenants of the property by the independent contractor, the cost of the services must be borne by the independent contractor, a separate charge must be made for the services, the amount of the separate charge must be received and retained by the independent contractor, and the independent contractor must be adequately compensated for the services.

(ii) *Trustee or director functions.* The trustees or directors of the real estate investment trust are not required to delegate or contract out their fiduciary duty to manage the trust itself, as distinguished from rendering or furnishing services to the tenants of its property or managing or operating the property. Thus, the trustees or directors may do all those things necessary, in their fiduciary capacities, to manage and conduct the affairs of the trust itself. For example, the trustees or directors may establish rental terms, choose tenants, enter into and renew leases, and deal with taxes, interest, and insurance, relating to the trust's property. The trustees or directors may also make capital expenditures with respect to the trust's property (as defined in section 263) and may make decisions as to repairs of the trust's property (of the type which would be deductible under section 162), the cost of which may be borne by the trust.

(iii) *Independent contractor defined.* The term ''independent contractor'' means—

(*a*) A person who does not own, directly or indirectly, at any time during the trust's taxable year more than 35 percent of the shares in the real estate investment trust, or

(*b*) A person—

(*1*) If a corporation, not more than 35 percent of the total combined voting power of whose stock (or 35 percent of the total shares of all classes of whose stock), or

(*2*) If not a corporation, not more than 35 percent of the interest in whose assets or net profits is owned, directly or indirectly, at any time during the trust's taxable year by one or more persons owning at any time during such taxable year 35 percent or more of the shares in the trust.

(iv) *Information required.* The real estate investment trust shall submit with its return for the taxable year (or before June 1, 1962, whichever is later) a statement setting forth the name and address of each independent contractor; and

(*a*) The highest percentage of the outstanding shares in the trust owned at any time during its taxable year by such independent contractor and by any person owning at any time during such taxable year any shares of stock or interest in the independent contractor.

(*b*) If the independent contractor is a corporation such statement shall set forth the highest percentage of the total combined voting power of its stock and the highest percentage of the total number of shares of all classes of its stock owned at any time during its taxable year by any person owning shares in the trust at any time during such taxable year.

(*c*) If the independent contractor is not a corporation such statement shall set forth the highest percentage of any interest in its assets or net profits owned at any time during its taxable year by any person owning shares in the trust at any time during such taxable year.

(6) *Amounts based on income or profits of subtenants.* (i) Except as provided in paragraph (b)(6)(ii) of this section, if a trust leases real property to a tenant under terms other than solely on a fixed sum rental (for example, a percentage of the tenant's gross receipts), and the tenant subleases all or a part of such property under an agreement which provides for a rental based in whole or in part on the income or profits of the sublessee, the entire amount of the rent received by the trust from the prime tenant with respect to such property is disqualified as ''rents from real property''.

(ii) *Exception.* For taxable years beginning after October 4, 1976, section

856(d)(4) provides an exception to the general rule that amounts received or accrued, directly or indirectly, by a real estate investment trust do not qualify as rents from real property if the determination of the amount depends in whole or in part on the income or profits derived by any person from the property. This exception applies where the trust rents property to a tenant (the prime tenant) for a rental which is based, in whole or in part, on a fixed percentage or percentages of the receipts or sales of the prime tenant, and the rent which the trust receives or accrues from the prime tenant pursuant to the lease would not qualify as ''rents from real property'' solely because the prime tenant receives or accrues from subtenants (including concessionaires) rents or other amounts based on the income or profits derived by a person from the property. Under the exception, only a proportionate part of the rent received or accrued by the trust does not qualify as ''rents from real property''. The proportionate part of the rent received or accrued by the trust which is nonqualified is the lesser of the following two amounts:

(A) The rent received or accrued by the trust from the prime tenant pursuant to the lease, that is based on a fixed percentage or percentages of receipts or sales, or

(B) The product determined by multiplying the total rent which the trust receives or accrues from the prime tenant pursuant to the lease by a fraction, the numerator of which is the rent or other amount received by the prime tenant that is based, in whole or in part, on the income or profits derived by any person from the property, and the denominator of which is the total rent or other amount received by the prime tenant from the property. For example, assume that a real estate investment trust owns land underlying a shopping center. The trust rents the land to the owner of the shopping center for an annual rent of $10x plus 2 percent of the gross receipts which the prime tenant receives from subtenants who lease space in the shopping center. Assume further that, for the year in question, the prime tenant derives total rent from the shopping center of $100x and, of that amount, $25x is received from subtenants whose rent is based, in whole or in part, on the income or profits derived from the property. Accordingly, the trust will receive a total rent of $12x, of which $2x is based on a percentage of the gross receipts of the prime tenant. The portion of the rent which is disqualified is the lesser of $2x (the rent received by the trust which is based on a percentage of gross receipts), or $3x, ($12x multiplied by $25x/$100x). Accordingly, $10x of the rent received by the trust qualifies as ''rents from real property'' and $2x does not qualify.

(7) *Attribution rules.* Paragraphs (2) and (3) of section 856(d) relate to direct or indirect ownership of stock, assets, or net profits by the persons described therein. For purposes of determining such direct or indirect ownership, the rules prescribed by section 318(a) (for determining the ownership of stock) shall apply except that ''10 percent'' shall be substituted for ''50 percent'' in section 318(a) (2)(C) and (3)(C).

(Sec. 856(d)(4) (90 Stat. 1750; 26 U.S.C. 856(d)(4)); sec. 856(e)(5) (88 Stat. 2113; 26 U.S.C. 856(e)(5)); sec. 856(f)(2) (90 Stat. 1751; 26 U.S.C. (856(f)(2)); sec. 856(g)(2) (90 Stat. 1753; 26 U.S.C. 856(g)(2)); sec. 858(a) (74 Stat. 1008; 26 U.S.C. 858(a)); sec. 859(c) (90 Stat. 1743; 26 U.S.C. 859(c)); sec. 859(e) (90 Stat. 1744; 26 U.S.C. 859(e)); sec. 6001 (68A Stat. 731; 26 U.S.C. 6001); sec. 6011 (68A Stat. 732; 26 U.S.C. 6011); sec. 6071 (68A Stat. 749, 26 U.S.C. 6071); sec. 6091 (68A Stat. 752; 26 U.S.C. 6091); sec. 7805 (68A Stat. 917; 26 U.S.C. 7805), Internal Revenue Code of 1954))

[T.D. 6598, 27 FR 4085, Apr. 28, 1962, as amended by T.D. 6969, 33 FR 12000, Aug. 23, 1968; T.D. 7767, 46 FR 11266, Feb. 6, 1981]

§ 1.856–5 Interest.

(a) *In general.* In computing the percentage requirements in section 856(c)(2)(B) and (3)(B), the term ''interest'' includes only an amount which constitutes compensation for the use or forbearance of money. For example, a fee received or accrued by a lender which is in fact a charge for services performed for a borrower rather than a charge for the use of borrowed money is not includable as interest.

(b) *Where amount depends on income or profits of any person.* Except as provided in paragraph (d) of this section, any amount received or accrued, directly or

indirectly, with respect to an obligation is not includable as interest for purposes of section 856(c) (2)(B) and (3)(B) if, under the principles set forth in paragraphs (b)(3) and (6)(i) of § 1.856–4, the determination of the amount depends in whole or in part on the income or profits of any person (whether or not derived from property secured by the obligation). Thus, for example, if in accordance with a loan agreement an amount is received or accrued by the trust with respect to an obligation which includes both a fixed amount of interest and a percentage of the borrower's income or profits, neither the fixed interest nor the amount based upon the percentage will qualify as interest for purposes of section 856(c) (2)(B) and (3)(B). This paragraph and paragraph (d) of this section apply only to amounts received or accrued in taxable years beginning after October 4, 1976, pursuant to loans made after May 27, 1976. For purposes of the preceding sentence, a loan is considered to be made before May 28, 1976, if it is made pursuant to a binding commitment entered into before May 28, 1976.

(c) *Apportionment of interest*—(1) *In general.* Where a mortgage covers both real property and other property, an apportionment of the interest income must be made for purposes of the 75-percent requirement of section 856(c)(3). For purposes of the 75-percent requirement, the apportionment shall be made as follows:

(i) If the loan value of the real property is equal to or exceeds the amount of the loan, then the entire interest income shall be apportioned to the real property.

(ii) If the amount of the loan exceeds the loan value of the real property, then the interest income apportioned to the real property is an amount equal to the interest income multiplied by a fraction, the numerator of which is the loan value of the real property, and the denominator of which is the amount of the loan. The interest income apportioned to the other property is an amount equal to the excess of the total interest income over the interest income apportioned to the real property.

(2) *Loan value.* For purposes of this paragraph, the loan value of the real property is the fair market value of the property, determined as of the date on which the commitment by the trust to make the loan becomes binding on the trust. In the case of a loan purchased by the trust, the loan value of the real property is the fair market value of the property, determined as of the date on which the commitment by the trust to purchase the loan becomes binding on the trust. However, in the case of a construction loan or other loan made for purposes of improving or developing real property, the loan value of the real property is the fair market value of the land plus the reasonably estimated cost of the improvements or developments (other than personal property) which will secure the loan and which are to be constructed from the proceeds of the loan. The fair market value of the land and the reasonably estimated cost of improvements or developments shall be determined as of the date on which a commitment to make the loan becomes binding on the trust. If the trust does not make the construction loan but commits itself to provide long-term financing following completion of construction, the loan value of the real property is determined by using the principles for determining the loan value for a construction loan. Moreover, if the mortgage on the real property is given as additional security (or as a substitute for other security) for the loan after the trust's commitment is binding, the real property loan value is its fair market value when it becomes security for the loan (or, if earlier, when the borrower makes a binding commitment to add or substitute the property as security).

(3) *Amount of loan.* For purposes of this paragraph, the amount of the loan means the highest principal amount of the loan outstanding during the taxable year.

(d) *Exception.* Section 856(f)(2) provides an exception to the general rule that amounts received, directly or indirectly, with respect to an obligation do not qualify as ''interest'' where the determination of the amounts depends in whole or in part on the income or profits of any person. The exception applies where the trust receives or accrues, with respect to the obligation of its debtor, an amount that is based in whole or in part on a fixed percentage

or percentages of receipts or sales of the debtor, and the amount would not qualify as interest solely because the debtor has receipts or sale proceeds that are based on the income or profits of any person. Under this exception only a proportionate part of the amount received or accrued by the trust fails to qualify as interest for purposes of the percentage-of-income requirements of section 856(c) (2) and (3). The proportionate part of the amount received or accrued by the trust that is non-qualified is the lesser of the following two amounts:

(1) The amount received or accrued by the trust from the debtor with respect to the obligation that is based on a fixed percentage or percentages of receipts or sales, or

(2) The product determined by multiplying by a fraction the total amount received or accrued by the trust from the debtor with respect to the obligation. The numerator of the fraction is the amount of receipts or sales of the debtor that is based, in whole or in part, on the income or profits of any person and the denominator is the total amount of the receipts or sales of the debtor. For purposes of the preceding sentence, the only receipts or sales to be taken into account are those taken into account in determining the payment to the trust pursuant to the loan agreement.

(Sec. 856(d)(4) (90 Stat. 1750; 26 U.S.C. 856(d)(4)); sec. 856(e)(5) (88 Stat. 2113; 26 U.S.C. 856(e)(5)); sec. 856(f)(2) (90 Stat. 1751; 26 U.S.C. (856(f)(2)); sec. 856(g)(2) (90 Stat. 1753; 26 U.S.C. 856(g)(2)); sec. 858(a) (74 Stat. 1008; 26 U.S.C. 858(a)); sec. 859(c) (90 Stat. 1743; 26 U.S.C. 859(c)); sec. 859(e) (90 Stat. 1744; 26 U.S.C. 859(e)); sec. 6001 (68A Stat. 731; 26 U.S.C. 6001); sec. 6011 (68A Stat. 732; 26 U.S.C. 6011); sec. 6071 (68A Stat. 749, 26 U.S.C. 6071); sec. 6091 (68A Stat. 752; 26 U.S.C. 6091); sec. 7805 (68A Stat. 917; 26 U.S.C. 7805), Internal Revenue Code of 1954)

[T.D. 7767, 46 FR 11268, Feb. 6, 1981]

§ 1.856–6 Foreclosure property.

(a) *In general.* Under section 856(e) a real estate investment trust may make an irrevocable election to treat as ''foreclosure property'' certain real property (including interests in real property), and any personal property incident to the real property, acquired by the trust after December 31, 1973. This section prescribes rules relating to the election, including rules relating to property eligible for the election. This section also prescribes rules relating to extensions of the general two-year period (hereinafter the ''grace period'') during which property retains its status as foreclosure property, as well as rules relating to early termination of the grace period under section 856(e)(4). The election to treat property as foreclosure property does not alter the character of the income derived therefrom (other than for purposes of section 856(c)(2)(F) and (3)(F)). For example, if foreclosure property is sold, the determination of whether it is property described in section 1221(1) will not be affected by the fact that it is foreclosure property.

(b) *Property eligible for the election*—(1) *Rules relating to acquisitions.* In general, the trust must acquire the property after December 31, 1973, as the result of having bid in the property at foreclosure, or having otherwise reduced the property to ownership or possession by agreement or process of law, after there was default (or default was imminent) on a lease of the property (where the trust was the lessor) or on an indebtedness owed to the trust which the property secured. Foreclosure property which secured an indebtedness owed to the trust is acquired for purposes of section 856(e) on the date on which the trust acquires ownership of the property for Federal income tax purposes. Foreclosure property which a trust owned and leased to another is acquired for purposes of section 856(e) on the date on which the trust acquires possession of the property from its lessee. A trust will not be considered to have acquired ownership of property for purposes of section 856(e) where it takes control of the property as a mortgagee-in-possession and cannot receive any profit or sustain any loss with respect to the property except as a creditor of the mortgagor. A trust may be considered to have acquired ownership of property for purposes of section 856(e) even through legal title to the property is held by another person. For example, where, upon foreclosure of a mortgage held by the trust, legal title to the property is acquired in the name of a

nominee for the exclusive benefit of the trust and the trust is the equitable owner of the property, the trust will be considered to have acquired ownership of the property for purposes of section 856(e). Generally, the fact that under local law the mortgagor has a right of redemption after foreclosure is not relevant in determining whether the trust has acquired ownership of the property for purposes of section 856(e). Property is not ineligible for the election solely because the property, in addition to securing an indebtedness owed to the trust, also secures debts owed to other creditors. Property eligible for the election includes a building or other improvement which has been constructed on land owned by the trust and which is acquired by the trust upon default of a lease of the land.

(2) *Personal property*. Personal property (including personal property not subject to a mortgage or lease of the real property) will be considered incident to a particular item of real property if the personal property is used in a trade or business conducted on the property or the use of the personal property is otherwise an ordinary and necessary corollary of the use to which the real property is put. In the case of a hotel, such items as furniture, appliances, linens, china, food, etc. would be examples of incidental personal property. Personal property incident to the real property is eligible for the election even though it is acquired after the real property is acquired or is placed in the building or other improvement in the course of the completion of construction.

(3) *Property with respect to which default is anticipated*. Property is not eligible for the election to be treated as foreclosure property if the loan or lease with respect to which the default occurs (or is imminent) was made or entered into (or the lease or indebtedness was acquired) by the trust with an intent to evict or foreclose, or when the trust knew or had reason to know that default would occur (''improper knowledge''). For purposes of the preceding sentence, a trust will not be considered to have improper knowledge with respect to a particular lease or loan, if the lease or loan was made pursuant to a binding commitment entered into by the trust at a time when it did not have improper knowledge. Moreover, if the trust, in an attempt to avoid default or foreclosure, advances additional amounts to the borrower in excess of amounts contemplated in the original loan commitment or modifies the lease or loan, such advance or modification will be considered not to have been made with an intent to evict or foreclose, or with improper knowledge, unless the original loan or lease was entered into with that intent or knowledge.

(c) *Election*—(1) *In general*. (i) An election to treat property as foreclosure property applies to all of the eligible real property acquired in the same taxable year by the trust upon the default (or as a result of the imminence of default) on a particular lease (where the trust is the lessor) or on a particular indebtedness owed to the trust. For example, if a loan made by a trust is secured by two separate tracts of land located in different cities, and in the same taxable year the trust acquires both tracts on foreclosure upon the default (or imminence of default) of the loan, the trust must include both tracts in the election. For a further example, the trust may choose to make a separate election for only one of the tracts if they are acquired in different taxable years or were not security for the same loan. If real property subject to the same election is acquired at different times in the same taxable year, the grace period for a particular property begins when that property is acquired.

(ii) If the trust acquires separate pieces of real property that secure the same indebtedness (or are under the same lease) in different taxable years because the trust delays acquiring one of them until a later taxable year, and the primary purpose for the delay is to include only one of them in an election, then if the trust makes an election for one piece it must also make an election for the other piece. A trust will not be considered to have delayed the acquisition of property for this purpose if there is a legitimate business reason for the delay (such as an attempt to avoid foreclosure by further negotiations with the debtor or lessee).

(iii) All of the eligible personal property incident to the real property must also be included in the election.

(2) *Time for making election.* The election to treat property as foreclosure property must be made on or before the due date (including extensions of time) for filing the trust's income tax return for the taxable year in which the trust acquires the property with respect to which the election is being made, or April 3, 1975, whichever is later.

(3) *Manner of making the election.* An election made after February 6, 1981, shall be made by a statement attached to the income tax return for the taxable year in which the trust acquired the property with respect to which the election is being made. The statement shall indicate that the election is made under section 856(e) and shall identify the property to which the election applies. The statement shall also set forth—

(i) The name, address, and taxpayer identification number of the trust,

(ii) The date the property was acquired by the trust, and

(iii) A brief description of how the real property was acquired, including the name of the person or persons from whom the real property was acquired and a description of the lease or indebtedness with respect to which default occurred or was imminent.

An election made on or before February 6, 1981 shall be filed in the manner prescribed in 26 CFR 10.1(f) (revised as of April 1, 1977) (temporary regulations relating to the election to treat property as foreclosure property) as in effect when the election is made.

(4) *Status of taxpayer.* In general, a taxpayer may make an election with respect to an acquisition of property only if the taxpayer is a qualified real estate investment trust for the taxable year in which the acquisition occurs. If, however, the taxpayer establishes, to the satisfaction of the district director for the internal revenue district in which the taxpayer maintains its principal place of business or principal office or agency, that its failure to be a qualified real estate investment trust for a taxable year was to due to reasonable cause and not due to willful neglect, the taxpayer may make the election with respect to property acquired in such taxable year. The principles of §§ 1.856.7(c) and 1.856.8(d) (including the principles relating to expert advice) will apply in determining whether, for purposes of this subparagraph, the failure of the taxpayer to be a qualified real estate investment trust for the taxable year in which the property is acquired was due to reasonable cause and not due to willful neglect. If a taxpayer makes a valid election to treat property as foreclosure property, the property will not lose its status as foreclosure property solely because the taxpayer is not a qualified real estate investment trust for a subsequent taxable year (including a taxable year which encompasses an extension of the grace period). However, the rules relating to the termination of foreclosure property status in section 856(e)(4) (but not the tax on income from foreclosure property imposed by section 857(b)(4)) apply to the year in which the property is acquired and all subsequent years, even though the taxpayer is not a qualified real estate investment trust for such year.

(d) *Termination of 2-year grace period; subsequent leases*—(1) *In general.* Under section 856(e)(4)(A), all real property (and any incidental personal property) for which a particular election has been made (see paragraph (c)(1) of this section) shall cease to be foreclosure property on the first day (occurring on or after the day on which the trust acquired the property) on which the trust either—

(i) Enters into a lease with respect to any of the property which, by its terms, will give rise to income of the trust which is not described in section 856(c)(3) (other than section 856(c)(3)(F)), or

(ii) Receives or accrues, directly or indirectly, any amount which is not described in section 856(c)(3) (other than section 856(c)(3)(F)) pursuant to a lease with respect to any of the real property entered into by the trust on or after the day the trust acquired the property.

For example, assume the trust acquires, in a particular taxable year, a shopping center upon the default of an indebtedness owed to the trust. Also assume that the trust subsequently enters into a lease with respect to one of

several stores in the shopping center that requires the lessee to pay rent to the trust which is not income described in section 856(c)(3) (other than section 856(c)(3)(F)). In such case, the entire shopping center will cease to be foreclosure property on the day the trust enters into the lease.

(2) *Extensions or renewals of leases.* Generally, the extension or renewal of a lease of foreclosure property will be treated as the entering into of a new lease only if the trust has a right to renegotiate the terms of the lease. If, however, by operation of law or by contract, the acquisition of the foreclosure property by the trust terminates a preexisting lease of the property, or gives the trust a right to terminate the lease, then for purposes of section 856(e)(4)(A), a trust, in such circumstances, will not be considered to have entered into a lease with respect to the property solely because the terms of the preexisting lease are continued in effect after foreclosure without substantial modification. The letting of rooms in a hotel or motel does not constitute the entering into a lease for purposes of section 856(e)(4)(A).

(3) *Rent attributable to personal property.* Solely for the purposes of section 856(e)(4)(A), if a trust enters into a lease with respect to real property on or after the day upon which the trust acquires such real property by foreclosure, and a portion of the rent from such lease is attributable to personal property which is foreclosure property incident to such real property, such rent attributable to the incidental personal property will not be considered to terminate the status of such real property (or such incidental personal property) as foreclosure property.

(e) *Termination of 2-year grace period; completion of construction*—(1) *In general.* Under section 856(e)(4)(B), all real property (and any incidental personal property) for which a particular election has been made (see paragraph (c)(1) of this section) shall cease to be foreclosure property on the first day (occurring on or after the day on which the trust acquired the property) on which any construction takes place on the property, other than completion of a building (or completion of any other improvement) where more than 10 percent of the construction of the building (or other improvement) was completed before default became imminent. If more than one default occurred with respect to an indebtedness or lease in respect of which there is an acquisition, the more-than-10-percent test (including the rule prescribed in this paragraph relating to the test) will not be applied at the time a particular default became imminent if it is clear that the acquisition did not occur as the result of such default. For example, if the debtor fails to make four consecutive payments of principal and interest on the due dates, and the trust takes action to acquire the property securing the debt only after the fourth default becomes imminent, the 10-percent test is applied at the time the fourth default became imminent (even though the trust would not have foreclosed on the property had not all four defaults occurred).

(2) *Determination of percentage of completion.* The determination of whether the construction of a building or other improvement was more than 10 percent complete when default became imminent shall be made by comparing the total direct costs of construction incurred with respect to the building or other improvement as of the date default became imminent with the estimated total direct costs of construction as of such date. If the building or other improvement qualifies as more than 10 percent complete under this method, the building or other improvement shall be considered to be more than 10 percent complete. For purposes of this subparagraph, direct costs of construction include the cost of labor and materials which are directly connected with the construction of the building or improvement.

Thus, for example, direct costs of construction incurred as of the date default became imminent would include amounts paid, or for which liability has been incurred, for labor which has been performed as of such date that is directly connected with the construction of the building or other improvement and for building materials and supplies used or consumed in connection with the construction as of such date. For purposes of applying the 10-percent test the trust may also take

into account the cost of building materials and supplies which have been delivered to the construction site as of the date default became imminent and which are to be used or consumed in connection with the construction. On the other hand, architect's fees, administrative costs of the developer or builder, lawyers' fees, and expenses incurred in connection with obtaining zoning approval or building permits are not considerd to be direct costs of construction. Any construction by the trust as mortgagee-in-possession is considered to have taken place after default resulting in acquisition of the property became imminent. Generally, the trust's estimate of the total direct costs of completing construction as of the date the default became imminent will be accepted, provided that the estimate is reasonable, in good faith, and is based on all of the data reasonably available to the trust when the trust undertakes completion of construction of the building or other improvement. Appropriate documentation which shows that construction was more than 10 percent complete when default became imminent must be available at the principal place of business of the trust for inspection in connection with an examination of the income tax return. Construction includes the renovation of a building, such as the remodeling of apartments, or the renovation of an apartment building to convert rental units to a condominium. The renovation must be more than 10 percent complete (determined by comparing the total direct cost of the physical renovation which has been incurred when default became imminent with the estimated total direct cost of renovation as of such date) when default became immiment in order for the property not to lose its status as foreclosure property if the trust undertakes the renovation.

(3) *Modification of a building or improvement.* Generally, the terms ''building'' and ''improvement'' in section 856(e)(4)(B) mean the building or improvement (including any intergral part thereof) as planned by the mortgagor or lessee (or other person in possession of the property, if appropriate) as of the date default became imminent. The trust, however, may estimate the total direct costs of construction and complete the construction of the building or other improvement by modifying the building or other improvement as planned as of the date default became imminent so as to reduce the estimated direct cost of construction of the building or improvement. If the trust does so modify the planned construction of the building or improvement, the 10-percent test is to be applied by comparing the direct costs of construction incurred as of the date default became imminent that are attributable to the building or improvement as modified, with the estimated total direct costs (as of such date) of construction of the building or other improvement as modified. The trust, in order to meet the 10-percent test, may not, however, modify the planned building or improvement by reducing the estimated direct cost of construction to such an extent that the building or improvement is not functional.

Also, the trust may make subsequent modifications which increase the direct cost of construction of the building or improvement if such modifications—

(i) Are required by a Federal, State, or local agency, or

(ii) Are alterations that are either required by a prospective lessee or purchaser as a condition of leasing or buying the property or are necessary for the property to be used for the purpose planned at the time default became imminent.

Subdivision (ii) of the preceding sentence applies, however, only if the building or improvement, as modified, was more than 10 percent complete when default became imminent. A building completed by the trust will not cease to be foreclosure property solely because the building is used in a manner other than that planed by the defaulting mortgagor or lessee. Thus, for example, assume a trust acquired on foreclosure a planned apartment building which was 20 percent complete when default became imminent and that the trust completes the building without modifications which increase the direct cost of construction. The property will not cease to be foreclosure property by reason of section 856(e)(4)(B) solely because the trust

sells the dwelling units in the building as condominium units, rather than holding them for rent as planned by the defaulting mortgagor. (See, however, section 856(e)(4)(C) and paragraph (f)(2) of this section for rules relating to the requirement that where foreclosure property is used in a trade or business (including a trade or business of selling the foreclosure property), the trade or business must be conducted through an independent contractor after 90 days after the property is acquired.)

(4) *Application on building-by-building basis.* Generally the more than 10 percent test is to be applied on a building-by-building basis. Thus, for example, if a trust has foreclosed on land held by a developer building a housing subdivision, the trust may complete construction of the houses which were more than 10 percent complete when default became imminent. The trust, however, may not complete construction of houses which were only 10 percent (or less) complete, nor may the trust begin construction of other houses planned for the subdivision on which construction has not begun. The trust, however, may construct an additional building or improvement (whether or not the construction thereof has begun) which is an integral part of another building or other improvement that was more than 10 percent complete when default became imminent if the additional building or improvement and the other building or improvement, taken together as a unit, meet the more than 10 percent test. For purposes of this paragraph, an additional building or other improvement will be considered to be an integral part of another building or improvement if—

(i) It is ancillary to the other building or improvement and its principal intended use is to furnish services or facilities which either supplement the use of such other building or improvement or are necessary for such other building or improvement to be utilized in the manner or for the purpose for which it is intended, or

(ii) The buildings or improvements are intended to comprise constituent parts of an interdependent group of buildings or other improvements.

However, a building or other improvement will not be considered to be an integral part of another building or improvement unless the buildings or improvements were planned as part of the same overall construction plan or project before default became imminent. An additional building or other improvement (such as, for example, an outdoor swimming pool or a parking garage) may be considered to be an integral part of another building or improvement, even though the additional building or improvement was also intended to be used to provide facilities or services for use in connection with several other buildings or improvements which will not be completed. If the trust chooses not to undertake the construction of an additional building or other improvement which qualifies as an integral part of another building or improvement, so much of the costs of construction (including both the direct costs of construction incurred before the default became imminent and the estimated costs of completion) as are attributable to that ''integral part'' shall not be taken into account in determining whether any other building or improvement was more than 10 percent complete when default became imminent. For example, assume the trust acquires on foreclosure a property on which the defaulting mortgagor has begun construction of a motel. The motel, as planned by the mortgagor, was to consist of a two-story building containing 30 units, and two detached one-story wings, each of which was to contain 20 units. At the time default became imminent, the defaulting mortgagor had completed more than 10 percent of the construction of the two-story structure but the two wings, an access road, a parking lot, and an outdoor swimming pool planned for the motel were each less than 10 percent complete. The trust may construct the two wings of the motel, the access road, the parking lot, and the swimming pool: *Provided,* That the motel and the other improvements which the trust undertakes to construct, taken together as a unit, were more than 10 percent complete when default became imminent. If, however, the trust chooses not to undertake construction of the swimming pool, the

cost of construction attributable to the swimming pool, whether incurred before default became imminent or estimated as the cost of completion, shall not be taken into account in determining whether the trust can complete construction of the other buildings and improvements. For another example, assume that the trust acquires a planned shopping center on foreclosure. At the time default became imminent several large buildings intended to house shops and stores in the shopping center were more than 10 percent complete. Less than 10 percent of the construction, however, had been completed on a separate structure intended to house a bank. The bank was planned as a component of the shopping center in order to provide, in conjunction with the other shops and stores, a specific range and variety of goods and services with which to attract customers to the shopping center. The trust may complete construction of the bank: *Provided*, That the bank and the other buildings and improvements which the trust undertakes to complete, taken together as a unit, were more than 10 percent complete when default became imminent. If the trust chooses not to construct the bank, no actual or estimated construction costs attributable to the bank are to be taken into account in applying the 10-percent test with respect to the other buildings and improvements in the shopping center. For a third example, assume that a defaulting mortgagor had planned to construct two identical apartment buildings, A and B, on the same tract of land, that neither building is to provide substantial facilities or services to be used in connection with the other, and that only building A was more than 10 percent complete when default became imminent. The trust, in this case, may not complete building B. On the other hand, if the facts are the same except that pursuant to the plans of the defaulting mortgagor, one of the buildings is to contain the furnace and central air conditioning machinery for both buildings A and B, the trust may complete both buildings A and B: *Provided*, That, taken together as a unit, the two buildings meet the more-than-10-percent test.

(5) *Repair and maintenance*. Under this paragraph (e), ''construction'' does not include—

(i) The repair or maintenance of a building or other improvement (such as the replacement of worn or obsolete furniture and appliances) to offset normal wear and tear or obsolescence, and the restoration of property required because of damage from fire, storm, vandalism or other casualty,

(ii) The preparation of leased space for a new tenant which does not substantially extend the useful life of the building or other improvement or significantly increase its value, even though, in the case of commercial space, this preparation includes adapting the property to the conduct of a different business, or

(iii) The performing of repair or maintenance described in paragraph (e)(5)(i) of this section after property is acquired that was deferred by the defaulting party and that does not constitute renovation under paragraph (e)(2) of this section.

(6) *Independent contractor required*. If any construction takes place on the foreclosure property more than 90 days after the day on which such property was acquired by the trust, such construction must be performed by an independent contractor (as defined in section 856(d)(3) and §1.856–4(b)(5)(iii)) from whom the trust does not derive or receive any income. Otherwise, the property will cease to be foreclosure property.

(7) *Failure to complete construction*. Property will not cease to be foreclosure property solely because a trust which undertakes the completion of construction of a building or other improvement on the property that was more than 10 percent complete when default became imminent does not complete the construction. Thus, for example, if a trust continues construction of a building that was 20 percent complete when default became imminent, and the trust constructs an additional 40 percent of the building and then sells the property, the property will not lose its status as foreclosure property solely because the trust fails to complete construction of the building.

(f) *Termination of 2-year grace period; use of foreclosure property in a trade or business*—(1) *In general.* Under section 856(e)(4)(C), all real property (and any incidental personal property) for which a particular election has been made (see paragraph (c)(1) of this section) shall cease to be foreclosure property on the first day (occurring more than 90 days after the day on which the trust acquired the property) on which the property is used in a trade or business conducted by the trust, other than a trade or business conducted by the trust through an independent contractor from whom the trust itself does not derive or receive any income. (See section 856(d)(3) for the definition of independent contractor.)

(2) *Property held primarily for sale to customers.* For the purposes of section 856(e)(4)(C), foreclosure property held by the trust primarily for sale to customers in the ordinary course of a trade or business is considered to be property used in a trade or business conducted by the trust. Thus, if a trust holds foreclosure property (whether real property or personal property incident to real property) for sale to customers in the ordinary course of a trade or business more than 90 days after the day on which the trust acquired the real property, the trade or business of selling the property must be conducted by the trust through an independent contractor from whom the trust does not derive or receive any income. Otherwise, after such 90th day the property will cease to be foreclosure property.

(3) *Change in use.* Foreclosure property will not cease to be foreclosure property solely because the use of the property in a trade or business by the trust differs from the use to which the property was put by the person from whom it was acquired. Thus, for example, if a trust acquires a rental apartment building on foreclosure, the property will not cease to be foreclosure property solely because the trust converts the building to a condominium apartment building and, through an independent contractor from whom the trust derives no income, engages in the trade or business of selling the individual condominium units.

(g) *Extension of 2-year grace period*—(1) *In general.* A real estate investment trust may apply to the district director of the internal revenue district in which is located the principal place of business (or principal office or agency) of the trust for an extension of the 2-year grace period. If the trust establishes to the satisfaction of the district director that an extension of the grace period is necessary for the orderly liquidation of the trust's interest in foreclosure property, or for an orderly renegotiation of a lease or leases of the property, the district director may extend the 2-year grace period. See section 856(e)(3) (as in effect with respect to the particular extension) for rules relating to the maximum length of an extension, and the number of extensions which may be granted. An extension of the grace period may be granted by the district director either before or after the date on which the grace period, but for the extension, would expire. The extension shall be effective as of the date on which the grace period, but for the extension, would expire.

(2) *Showing required.* Generally, in order to establish the necessity of an extension, the trust must demonstrate that it has made good faith efforts to renegotiate leases with respect to, or dispose of, the foreclosure property. In certain cases, however, the trust may establish the necessity of an extension even though it has not made such efforts. For example, if the trust demonstrates that, for valid business reasons, construction of the foreclosure property could not be completed before the expiration of the grace period, the necessity of the extension could be established even though the trust had made no effort to sell the property. For another example, if the trust demonstrates that due to a depressed real estate market, it could not sell the foreclosure property before the expiration of the grace period except at a distress price, the necessity of an extension could be established even though the trust had made no effort to sell the property. The fact that property was acquired as foreclosure property prior to January 3, 1975 (the date of enactment of section 856(e)), generally will be considered as a factor (but not a

controlling factor) which tends to establish that an extension of the grace period is necessary.

(3) *Time for requesting an extension of the grace period.* A request for an extension of the grace period must be filed with the appropriate district director more than 60 days before the day on which the grace period would otherwise expire. In the case of a grace period which would otherwise expire before August 6, 1976, a request for an extension will be considered to be timely filed if filed on or before June 7, 1976.

(4) *Information required.* The request for an extension of the grace period shall identify the property with respect to which the request is being made and shall also include the following information:

(i) The name, address, and taxpayer identification number of the trust,

(ii) The date the property was acquired as foreclosure property by the trust,

(iii) The taxable year of the trust in which the property was acquired,

(iv) If the trust has been previously granted an extension of the grace period with respect to the property, a statement to that effect (which shall include the date on which the grace period, as extended, expires) and a copy of the information which accompanied the request for the previous extension,

(v) A statement of the reasons why the grace period should be extended,

(vi) A description of any efforts made by the trust after the acquisition of the property to dispose of the property or to renegotiate any lease with respect to the property, and

(vii) A description of any other factors which tend to establish that an extension of the grace period is necessary for the orderly liquidation of the trust's interest in the property, or for an orderly renegotiation of a lease or leases of the property.

The trust shall also furnish any additional information requested by the district director after the request for extension is filed.

(5) *Automatic extension.* If a real estate investment trust files a request for an extension with the district director more than 60 days before the expiration of the grace period, the grace period shall be considered to be extended until the end of the 30th day after the date on which the district director notifies the trust by certified mail sent to its last known address that the period of extension requested by the trust is not granted. For further guidance regarding the definition of last known address, see §301.6212–2 of this chapter. In no event, however, shall the rule in the preceding sentence extend the grace period beyond the expiration of (i) the period of extension requested by the trust, or (ii) the 1-year period following the date that the grace period (but for the automatic extension) would expire. The date of the postmark on the sender's receipt is considered to be the date of the certified mail for purposes of this subparagraph. This subparagraph does not apply, however, if the date of the notification by certified mail described in the first sentence is more than 30 days before the date that the grace period (determined without regard to this subparagraph) expires. Moreover, this subparagraph shall not operate to allow any period of extension that is prohibited by the last sentence of section 856(e)(3) (as in effect with respect to the particular extension).

(6) *Extension of time for filing.* If a real estate investment trust fails to file the request for an extension of the grace period within the time provided in paragraph (g)(3) of this section, then the district director shall grant a reasonable extension of time for filing such request, provided (i) it is established to the satisfaction of the district director that there was reasonable cause for failure to file the request within the prescribed time and (ii) a request for such extension is filed within such time as the district director considers reasonable under the circumstances.

(7) *Status of taxpayer.* The reference to ''real estate investment trust'' or ''trust'' in this paragraph (g) shall be considered to include a taxpayer that is not a qualified real estate investment trust, if the taxpayer establishes to the satisfaction of the district director that its failure to be a qualified real estate investment trust for the taxable year was due to reasonable cause and not due to willful neglect. The principles of §1.856–7(c) and §1.856–

8(d) (including the principles relating to expert advice) shall apply for determining reasonable cause (and absence of willful neglect) for this purpose.

(Sec. 856(d)(4) (90 Stat. 1750; 26 U.S.C. 856(d)(4)); sec. 856(e)(5) (88 Stat. 2113; 26 U.S.C. 856(e)(5)); sec. 856(f)(2) (90 Stat. 1751; 26 U.S.C. (856(f)(2)); sec. 856(g)(2) (90 Stat. 1753; 26 U.S.C. 856(g)(2)); sec. 858(a) (74 Stat. 1008; 26 U.S.C. 858(a)); sec. 859(c) (90 Stat. 1743; 26 U.S.C. 859(c)); sec. 859(e) (90 Stat. 1744; 26 U.S.C. 859(e)); sec. 6001 (68A Stat. 731; 26 U.S.C. 6001); sec. 6011 (68A Stat. 732; 26 U.S.C. 6011); sec. 6071 (68A Stat. 749, 26 U.S.C. 6071); sec. 6091 (68A Stat. 752; 26 U.S.C. 6091); sec. 7805 (68A Stat. 917; 26 U.S.C. 7805), Internal Revenue Code of 1954))

[T.D. 7767, 46 FR 11269, Feb. 6, 1981; 46 FR 15263, Mar. 5, 1981, as amended by T.D. 8939, 66 FR 2819, Jan. 12, 2001]

§ 1.856–7 Certain corporations, etc., that are considered to meet the gross income requirements.

(a) *In general.* A corporation, trust, or association which fails to meet the requirements of paragraph (2) or (3) of section 856(c), or of both such paragraphs, for any taxable year nevertheless is considered to have satisfied these requirements if the corporation, trust, or association meets the requirements of subparagraphs (A), (B), and (C) of section 856(c)(7) (relating to a schedule attached to the return, the absence of fraud, and reasonable cause).

(b) *Contents of the schedule.* The schedule required by subparagraph (A) of section 856(c)(7) must contain a breakdown, or listing, of the total amount of gross income falling under each of the separate subparagraphs of section 856(c) (2) and (3). Thus, for example, the real estate investment trust, for purposes of listing its income from the sources described in section 856(c)(2), would list separately the total amount of dividends, the total amount of interest, the total amount of rents from real property, etc. The listing is not required to be on a lease-by-lease, loan-by-loan, or project-by-project basis, but the real estate investment trust must maintain adequate records on such a basis with which to substantiate each total amount listed in the schedule.

(c) *Reasonable cause*—(1) *In general.* The failure to meet the requirements of paragraph (2) or (3) of section 856(c) (or of both paragraphs) will be considered due to reasonable cause and not due to willful neglect if the real estate investment trust exercised ordinary business care and prudence in attempting to satisfy the requirements. Such care and prudence must be exercised at the time each transaction is entered into by the trust. However, even if the trust exercised ordinary business care and prudence in entering into a transaction, if the trust later determines that the transaction results in the receipt or accrual of nonqualified income and that the amounts of such nonqualified income, in the context of the trust's overall portfolio, reasonably can be expected to cause a source-of-income requirement to be failed, the trust must use ordinary business care and prudence in an effort to renegotiate the terms of the transaction, dispose of property acquired or leased in the transaction, or alter other elements of its portfolio. In any case, failure to meet an income source requirement will be considered due to willful neglect and not due to reasonable cause if the failure is willful and the trust could have avoided such failure by taking actions not inconsistent with ordinary business care and prudence. For example, if the trust enters into a lease knowing that it will produce nonqualified income which reasonably can be expected to cause a source-of-income requirement to be failed, the failure is due to willful neglect even if the trust has a legitimate business purpose for entering into the lease.

(2) *Expert advice*—(i) *In general.* The reasonable reliance on a reasoned, written opinion as to the characterization for purposes of section 856 of gross income to be derived (or being derived) from a transaction generally constitutes ''reasonable cause'' if income from that transaction causes the trust to fail to meet the requirements of paragraph (2) or (3) of section 856(c) (or of both paragraphs). The absence of such a reasoned, written opinion with respect to a transaction does not, by itself, give rise to any inference that

the failure to meet a percentage of income requirement was without reasonable cause. An opinion as to the character of income from a transaction includes an opinion pertaining to the use of a standard form of transaction or standard operating procedure in a case where such standard form or procedure is in fact used or followed.

(ii) If the opinion indicates that a portion of the income from a transaction will be nonqualifed income, the trust must still exercise ordinary business care and prudence with respect to the nonqualified income and determine that the amount of that income, in the context of its overall portfolio, reasonably cannot be expected to cause a source-of-income requirement to be failed. Reliance on an opinion is not reasonable if the trust has reason to believe that the opinion is incorrect (for example, because the trust withholds facts from the person rendering the opinion).

(iii) *Reasoned written opinion.* For purposes of this subparagraph (2), a written opinion means an opinion, in writing, rendered by a tax advisor (including house counsel) whose opinion would be relied on by a person exercising ordinary business care and prudence in the circumstances of the particular transaction. A written opinion is considered ''reasoned'' even if it reaches a conclusion which is subsequently determined to be incorrect, so long as the opinion is based on a full disclosure of the factual situation by the real estate investment trust and is addressed to the facts and law which the person rendering the opinion believes to be applicable. However, an opinion is not considered ''reasoned'' if it does nothing more than recite the facts and express a conclusion.

(d) *Application of section 856(c)(7) to taxable years beginning before October 5, 1976.* Pursuant to section 1608(b) of the Tax Reform Act of 1976, paragraph (7) of section 856(c) and this section apply to a taxable year of a real estate investment trust which begins before October 5, 1976, only if as the result of a determination occurring after October 4, 1976, the trust does not meet the requirements of paragraph (2) or (3) of section 856(c), or both paragraphs, as in effect for the taxable year. The requirement that the schedule described in subparagraph (A) of section 856(c)(7) be attached to the income tax return of a real estate investment trust in order for section 856(c)(7) to apply is not applicable to taxable years beginning before October 5, 1976. For purposes of section 1608(b) of the Tax Reform Act of 1976 and this paragraph, the rules relating to determinations prescribed in section 860(e) and §1.860–2(b)(1) (other than the second, third, and last sentences of §1.860–2(b)(1)(ii)) shall apply. However, a determination consisting of an agreement between the taxpayer and the district director (or other official to whom authority to sign the agreement is delegated) shall set forth the amount of gross income for the taxable year to which the determination applies, the amount of the 90 percent and 75 percent source-of-income requirements for the taxable year to which the determination applies, and the amount by which the real estate investment trust failed to meet either or both of the requirements. The agreement shall also set forth the amount of tax for which the trust is liable pursuant to section 857(b)(5). The agreement shall also contain a finding as to whether the failure to meet the requirements of paragraph (2) or (3) of section 856(c) (or of both paragraphs) was due to reasonable cause and not due to willful neglect.

(Sec. 856(d)(4) (90 Stat. 1750; 26 U.S.C. 856(d)(4)); sec. 856(e)(5) (88 Stat. 2113; 26 U.S.C. 856(e)(5)); sec. 856(f)(2) (90 Stat. 1751; 26 U.S.C. (856(f)(2)); sec. 856(g)(2) (90 Stat. 1753; 26 U.S.C. 856(g)(2)); sec. 858(a) (74 Stat. 1008; 26 U.S.C. 858(a)); sec. 859(c) (90 Stat. 1743; 26 U.S.C. 859(c)); sec. 859(e) (90 Stat. 1744; 26 U.S.C. 859(e)); sec. 6001 (68A Stat. 731; 26 U.S.C. 6001); sec. 6011 (68A Stat. 732; 26 U.S.C. 6011); sec. 6071 (68A Stat. 749, 26 U.S.C. 6071); sec. 6091 (68A Stat. 752; 26 U.S.C. 6091); sec. 7805 (68A Stat. 917; 26 U.S.C. 7805), Internal Revenue Code of 1954); sec. 860(e) (92 Stat. 2849, 26 U.S.C. 860(e)); sec. 860(g) (92 Stat. 2850, 26 U.S.C. 860(g)))

[T.D. 7767, 46 FR 11274, Feb. 6, 1981, as amended by T.D. 7936, 49 FR 2106, Jan. 18, 1984]

§1.856–8 Revocation or termination of election.

(a) *Revocation of an election to be a real estate investment trust.* A corporation, trust, or association that has made an election under section 856(c)(1)

to be a real estate investment trust may revoke the election for any taxable year after the first taxable year for which the election is effective. The revocation must be made by filing a statement with the district director for the internal revenue district in which the taxpayer maintains its principal place of business or principal office or agency. The statement must be filed on or before the 90th day after the first day of the first taxable year for which the revocation is to be effective. The statement must be signed by an official authorized to sign the income tax return of the taxpayer and must—

(1) Contain the name, address, and taxpayer identification number of the taxpayer,

(2) Specify the taxable year for which the election was made, and

(3) Include a statement that the taxpayer, pursuant to section 856(g)(2), revokes its election under section 856(c)(1) to be a real estate investment trust.

The revocation may be made only with respect to a taxable year beginning after October 4, 1976, and is effective for the taxable year in which made and for all succeeding taxable years. A revocation with respect to a taxable year beginning after October 4, 1976, that is filed before February 6, 1981, in the time and manner prescribed in § 7.856(g)–1 of this chapter (as in effect when the revocation was filed) is considered to meet the requirements of this paragraph.

(b) *Termination of election to be a real estate investment trust.* An election of a corporation, trust, or association under section 856(c)(1) to be a real estate investment trust shall terminate if the corporation, trust, or association is not a qualified real estate investment trust for any taxable year (including the taxable year with respect to which the election is made) beginning after October 4, 1976. (This election terminates whether the failure to be a qualified real estate investment trust is intentional or inadvertent.) The term ''taxable year'' includes a taxable year of less than 12 months for which a return is made under section 443. The termination of the election is effective for the first taxable year beginning after October 4, 1976, for which the corporation, trust, or association is not a qualified real estate investment trust and for all succeeding taxable years.

(c) *Restrictions on election after termination or revocation*—(1) *General rule.* Except as provided in paragraph (d) of this section, if a corporation, trust, or association has made an election under section 856(c)(1) to be a real estate investment trust and the election has been terminated or revoked under section 856(g)(1) or (2), the corporation, trust, or association (and any successor corporation, trust, or association) is not eligible to make a new election under section 856(c)(1) for any taxable year prior to the fifth taxable year which begins after the first taxable year for which the termination or revocation is effective.

(2) *Successor corporation.* The term ''successor corporation, trust, or association'', as used in section 856(g)(3), means a corporation, trust, or association which meets both a continuity of ownership requirement and a continuity of assets requirement with respect to the corporation, trust, or association whose election has been terminated under section 856(g)(1) or revoked under section 856(g)(2). A corporation, trust, or association meets the continuity of ownership requirement only if at any time during the taxable year the persons who own, directly or indirectly, 50 percent or more in value of its outstanding shares owned, at any time during the first taxable year for which the termination or revocation was effective, 50 percent or more in value of the outstanding shares of the corporation, trust, or association whose election has been terminated or revoked. A corporation, trust, or association meets the continuity of assets requirement only if either (i) a substantial portion of its assets were assets of the corporation, trust, or association whose election has been revoked or terminated, or (ii) it acquires a substantial portion of the assets of the corporation, trust, or association whose election has been terminated or revoked.

(3) *Effective date.* Section 856(g)(3) does not apply to the termination of an election that was made by a taxpayer

pursuant to section 856(c)(1) on or before October 4, 1976, unless the taxpayer is a qualified real estate investment trust for a taxable year ending after October 4, 1976, for which the pre-October 5, 1976, election is in effect. For example, assume that Trust X, a calendar year taxpayer, files a timely election under section 856(c)(1) with respect to its taxable year 1974, and is a qualified real estate investment trust for calendar years 1974 and 1975. Assume further that Trust X is not a qualified real estate investment trust for 1976 and 1977 because it willfully fails to meet the asset diversification requirements of section 856(c)(5) for both years. The failure (whether or not willful) to meet these requirements in 1977 terminates the election to be a real estate investment trust made with respect to 1974. (See paragraph (b) of this section.) The termination is effective for 1977 and all succeeding taxable years. However, under section 1608(d)(3) of the Tax Reform Act of 1976, Trust X is not prohibited by section 856(g)(3) from making a new election under section 856(c)(1) with respect to 1978.

(d) *Exceptions.* Section 856(g)(4) provides an exception to the general rule of section 856(g)(3) that the termination of an election to be a real estate investment trust disqualifies the corporation, trust, or association from making a new election for the 4 taxable years following the first taxable year for which the termination is effective. This exception applies where the corporation, trust, or association meets the requirements of section 856(g)(4)(A), (B) and (C) (relating to the timely filing of a return, the absence of fraud, and reasonable cause, respectively) for the taxable year with respect to which the termination of election occurs. In order to meet the requirements of section 856(g)(4)(C), the corporation, trust, or association must establish, to the satisfaction of the district director for the internal revenue district in which the corporation, trust, or association maintains its principal place of business or principal office or agency, that its failure to be a qualified real estate investment trust for the taxable year in question was due to reasonable cause and not due to willful neglect. The principles of § 1.856–7(c) (including the principles relating to expert advice) will apply in determining whether, for purposes of section 856(g)(4), the failure of a corporation, trust, or association to be a qualified real estate investment trust for a taxable year was due to reasonable cause and not due to willful neglect. Thus, for example, the corporation, trust, or association must exercise ordinary business care and prudence in attempting to meet the status conditions of section 856(a) and the distribution and recordkeeping requirements of section 857(a), as well as the gross income requirements of section 856(c). The provisions of section 856(g)(4) do not apply to a taxable year in which the corporation, trust, or association makes a valid revocation, under section 856(g)(2), of an election to be a real estate investment trust.

(Sec. 856(d)(4) (90 Stat. 1750; 26 U.S.C. 856(d)(4)); sec. 856(e)(5) (88 Stat. 2113; 26 U.S.C. 856(e)(5)); sec. 856(f)(2) (90 Stat. 1751; 26 U.S.C. (856(f)(2)); sec. 856(g)(2) (90 Stat. 1753; 26 U.S.C. 856(g)(2)); sec. 858(a) (74 Stat. 1008; 26 U.S.C. 858(a)); sec. 859(c) (90 Stat. 1743; 26 U.S.C. 859(c)); sec. 859(e) (90 Stat. 1744; 26 U.S.C. 859(e)); sec. 6001 (68A Stat. 731; 26 U.S.C. 6001); sec. 6011 (68A Stat. 732; 26 U.S.C. 6011); sec. 6071 (68A Stat. 749, 26 U.S.C. 6071); sec. 6091 (68A Stat. 752; 26 U.S.C. 6091); sec. 7805 (68A Stat. 917; 26 U.S.C. 7805), Internal Revenue Code of 1954))

[T.D. 7767, 46 FR 11275, Feb. 6, 1981; 46 FR 15263, Mar. 5, 1981]

§ 1.856–9 Treatment of certain qualified REIT subsidiaries.

(a) *In general.* A qualified REIT subsidiary, even though it is otherwise not treated as a corporation separate from the REIT, is treated as a separate corporation for purposes of:

(1) Federal tax liabilities of the qualified REIT subsidiary with respect to any taxable period for which the qualified REIT subsidiary was treated as a separate corporation.

(2) Federal tax liabilities of any other entity for which the qualified REIT subsidiary is liable.

(3) Refunds or credits of Federal tax.

(b) *Examples.* The following examples illustrate the application of paragraph (a) of this section:

Example 1. X, a calendar year taxpayer, is a domestic corporation 100 percent of the stock of which is acquired by Y, a real estate

investment trust, in 2002. X was not a member of a consolidated group at any time during its taxable year ending in December 2001. Consequently, X is treated as a qualified REIT subsidiary under the provisions of section 856(i) for 2002 and later periods. In 2004, the Internal Revenue Service (IRS) seeks to extend the period of limitations on assessment for X's 2001 taxable year. Because X was treated as a separate corporation for its 2001 taxable year, X is the proper party to sign the consent to extend the period of limitations.

Example 2. The facts are the same as in *Example 1*, except that upon Y's acquisition of X, Y and X jointly elect under section 856(l) to treat X as a taxable REIT subsidiary of Y. In 2003, Y and X jointly revoke that election. Consequently, X is treated as a qualified REIT subsidiary under the provisions of section 856(i) for 2003 and later periods. In 2004, the IRS determines that X miscalculated and underreported its income tax liability for 2001. Because X was treated as a separate corporation for its 2001 taxable year, the deficiency may be assessed against X and, in the event that X fails to pay the liability after notice and demand, a general tax lien will arise against all of X's property and rights to property.

Example 3. X is a qualified REIT subsidiary of Y under the provisions of section 856(i). In 2001, Z, a domestic corporation that reports its taxes on a calendar year basis, merges into X in a state law merger. Z was not a member of a consolidated group at any time during its taxable year ending in December 2000. Under the applicable state law, X is the successor to Z and is liable for all of Z's debts. In 2004, the IRS seeks to extend the period of limitations on assessment for Z's 2000 taxable year. Because X is the successor to Z and is liable for Z's 2000 taxes that remain unpaid, X is the proper party to sign the consent to extend the period of limitations.

(c) *Effective date*. This section applies on or after April 1, 2004.

[T.D. 9183, 70 FR 9221, Feb. 25, 2005]

§ 1.857–1 Taxation of real estate investment trusts.

(a) *Requirements applicable thereto*. Section 857(a) denies the application of the provisions of part II, subchapter M, chapter 1 of the Code (other than sections 856(g), relating to the revocation or termination of an election, and 857(d), relating to earnings and profits) to a real estate investment trust for a taxable year unless—

(1) The deduction for dividends paid for the taxable year as defined in section 561 (computed without regard to capital gain dividends) equals or exceeds the amount specified in section 857(a)(1), as in effect for the taxable year; and

(2) The trust complies for such taxable year with the provisions of § 1.857–8 (relating to records required to be maintained by a real estate investment trust).

See section 858 and § 1.858–1, relating to dividends paid after the close of the taxable year.

(b) *Failure to qualify*. If a real estate investment trust does not meet the requirements of section 857(a) and paragraph (a) of this section for the taxable year, it will, even though it may otherwise be classified as a real estate investment trust, be taxed in such year as an ordinary corporation and not as a real estate investment trust. In such case, none of the provisions of part II of subchapter M (other than sections 856(g) and 857(d)) will be applicable to it. For the rules relating to the applicability of sections 856(g) and 857(d), see § 1.857–7.

(Sec. 856(d)(4) (90 Stat. 1750; 26 U.S.C. 856(d)(4)); sec. 856(e)(5) (88 Stat. 2113; 26 U.S.C. 856(e)(5)); sec. 856(f)(2) (90 Stat. 1751; 26 U.S.C. (856(f)(2)); sec. 856(g)(2) (90 Stat. 1753; 26 U.S.C. 856(g)(2)); sec. 858(a) (74 Stat. 1008; 26 U.S.C. 858(a)); sec. 859(c) (90 Stat. 1743; 26 U.S.C. 859(c)); sec. 859(e) (90 Stat. 1744; 26 U.S.C. 859(e)); sec. 6001 (68A Stat. 731; 26 U.S.C. 6001); sec. 6011 (68A Stat. 732; 26 U.S.C. 6011); sec. 6071 (68A Stat. 749, 26 U.S.C. 6071); sec. 6091 (68A Stat. 752; 26 U.S.C. 6091); sec. 7805 (68A Stat. 917; 26 U.S.C. 7805), Internal Revenue Code of 1954))

[T.D. 6598, 27 FR 4087, Apr. 28, 1962, as amended by T.D. 7767, 46 FR 11277, Feb. 6, 1981]

§ 1.857–2 Real estate investment trust taxable income and net capital gain.

(a) *Real estate investment trust taxable income*. Section 857(b)(1) imposes a nominal tax and surtax, computed at the rates and in the manner prescribed in section 11, on the ''real estate investment trust taxable income'', as defined in section 857(b)(2). Section 857(b)(2) requires certain adjustments to be made to convert taxable income of the real estate investment trust to ''real estate investment trust taxable income''. The adjustments are as follows:

(1) *Net capital gain*. In the case of taxable years ending before October 5, 1976, the net capital gain, if any, is excluded.

(2) *Special deductions disallowed*. The special deductions provided in part VIII, subchapter B, chapter 1 of the Code (except the deduction under section 248) are not allowed.

(3) *Deduction for dividends paid*—(i) *General rule*. The deduction for dividends paid (as defined in section 561) is allowed. In the case of taxable years ending before October 5, 1976, the deduction for dividends paid is computed without regard to capital gains dividends.

(ii) *Deduction for dividends paid if there is net income from foreclosure property*. If for any taxable year the trust has net income from foreclosure property (as defined in section 857(b)(4)(B) and §1.857–3), the deduction for dividends paid is an amount equal to the amount which bears the same proportion to the total dividends paid or considered as paid during the taxable year that otherwise meet the requirements for the deduction for dividends paid (as defined in section 561) as the real estate investment trust taxable income (determined without regard to the deduction for dividends paid) bears to the sum of—

(A) The real estate investment trust taxable income (determined without regard to the deduction for dividends paid), and

(B) The amount by which the net income from foreclosure property exceeds the tax imposed on such income by section 857(b)(4)(A).

For purposes of the preceding sentence, the term ''total dividends paid or considered as paid during the taxable year'' includes deficiency dividends paid with respect to the taxable year that are not otherwise excluded under this subdivision or section 857(b)(3)(A). The term, however, does not include either deficiency dividends paid during the taxable year with respect to a preceding taxable year ending before October 5, 1976, capital gains dividends.

(iii) *Deduction for dividends paid for purposes of the alternative tax*. The rules in section 857(b)(3)(A) apply in determining the amount of the deduction for dividends paid that is taken into account in computing the alternative tax. Thus, for example, if a real estate investment trust has net income from foreclosure property for a taxable year ending after October 4, 1976, then for purposes of determining the partial tax described in section 857(b)(3)(A)(i), the amount of the deduction for dividends paid is computed pursuant to paragraph (a)(3)(ii) of this section, except that capital gains dividends are excluded from the dividends paid or considered as paid during the taxable year, and the net capital gain is excluded in computing real estate investment trust taxable income.

(4) *Section 443(b) disregarded*. The taxable income is computed without regard to section 443(b). Thus, the taxable income for a period of less than 12 months is not placed on an annual basis even though the short taxable year results from a change of accounting period.

(5) *Net operating loss deduction*. In the case of a taxable year ending before October 5, 1976, the net operating loss deduction provided in section 172 is not allowed.

(6) *Net income from foreclosure property*. An amount equal to the net income from foreclosure property (as defined in section 857(b)(4)(B) and paragraph (a) of §1.857–3), if any, is excluded.

(7) *Tax imposed by section 857(b)(5)*. An amount equal to the tax (if any) imposed on the trust by section 857(b)(5) for the taxble year is excluded.

(8) *Net income or loss from prohibited transactions*. An amount equal to the amount of any net income derived from prohibited transactions (as defined in section 857(b)(6)(B)(i)) is excluded. On the other hand, an amount equal to amount of any net loss derived from prohibited transactions (as defined in section 857(b)(6)(B)(ii)) is included. Because the amount of the net loss derived from prohibited transactions is taken into account in computing taxable income before the adjustments required by section 857(b)(2) and this section are made, the effect of including an amount equal to the amount of the loss is to disallow a deduction for the loss.

(b) *Net capital gain in taxable years ending October 5, 1976*. The rules relating to the taxation of capital gains in 26 CFR 1.857–2(b) (revised as of April 1, 1977) apply to taxable years ending before October 5, 1976.

(Sec. 856(d)(4) (90 Stat. 1750; 26 U.S.C. 856(d)(4)); sec. 856(e)(5) (88 Stat. 2113; 26 U.S.C. 856(e)(5)); sec. 856(f)(2) (90 Stat. 1751; 26 U.S.C. (856(f)(2)); sec. 856(g)(2) (90 Stat. 1753; 26 U.S.C. 856(g)(2)); sec. 858(a) (74 Stat. 1008; 26 U.S.C. 858(a)); sec. 859(c) (90 Stat. 1743; 26 U.S.C. 859(c)); sec. 859(e) (90 Stat. 1744; 26 U.S.C. 859(e)); sec. 6001 (68A Stat. 731; 26 U.S.C. 6001); sec. 6011 (68A Stat. 732; 26 U.S.C. 6011); sec. 6071 (68A Stat. 749, 26 U.S.C. 6071); sec. 6091 (68A Stat. 752; 26 U.S.C. 6091); sec. 7805 (68A Stat. 917; 26 U.S.C. 7805), Internal Revenue Code of 1954))

[T.D. 7767, 46 FR 11277, Feb. 6, 1981]

§ 1.857–3 Net income from foreclosure property.

(a) *In general*. For purposes of section 857(b)(40(B), net income from foreclosure property means the aggregate of—

(1) All gains and losses from sales or other dispositions of foreclosure property described in section 1221(1), and,

(2) The difference (hereinafter called ''net gain or loss from operations'') between (i) the gross income derived from foreclosure property (as defined in section 856(e)) to the extent such gross income is not described in subparagraph (A), (B), (C), (D), (E), or (G) of section 856(c)(3), and (ii) the deductions allowed by chapter 1 of the Code which are directly connected with the production of such gross income.

Thus, the sum of the gains and losses from sales or other dispositions of foreclosure property described in section 1221(1) is aggregated with the net gain or loss from operations in arriving at net income from foreclosure property. For example, if for a taxable year a real estate investment trust has gain of $100 from the sale of an item of foreclosure property described in section 1221(1), a loss of $50 from the sale of an item of foreclosure property described in section 1221(1), gross income of $25 from the rental of foreclosure property that is not gross income described in subparagraph (A), (B), (C), (D), or (G) of section 856(c)(3), and deductions of $35 allowed by chapter 1 of the Code which are directly connected with the production of the rental income, the net income from foreclosure property for the taxable years is $40 (($100 − $50) + ($25 − $35)).

(b) *Directly connected deductions*. A deduction which is otherwise allowed by chapter 1 of the Code is ''directly connected'' with the production of gross income from the foreclosure property if it has a proximate and primary relationship to the earning of the income. Thus, in the case of gross income from real property that is foreclosure property, ''directly connected'' deductions would include depreciation on the property, interest paid or accrued on the indebtedness of the trust (whether or not secured by the property) to the extent attributable to the carrying of the property, real estate taxes, and fees paid to an independent contractor hired to manage the property. On the other hand, general overhead and administrative expenses of the trust are not ''directly connected'' deductions. Thus, salaries of officers and other administrative employees of the trust are not ''directly connected'' deductions. The net operating loss deduction provided by section 172 is not allowed in computing net income from foreclosure property.

(c) *Net loss from foreclosure property*. The tax imposed by section 857(b)(4) applies only if there is net income from foreclosure property. If there is a net loss from foreclosure property (that is, if the aggregate computed under paragraph (a) of this section results in a negative amount) the loss is taken into account in computing real estate investment trust taxable income under section 857(b)(2).

(d) *Gross income not subject to tax on foreclosure property*. If the gross income derived from foreclosure property consists of two classes, a deduction directly connected with the production of both classes (including interest attributable to the carrying of the property) must be apportioned between them. The two classes are:

(1) Gross income which is taken into account in computing net income from foreclosure property and

(2) Other income (such as income described in subparagraph (A), (B), (C), (D), or (G) of section 856(c)(3)).

The apportionment may be made on any reasonable basis.

(e) *Allocation and apportionment of interest.* For purposes of determining the amount of interest attributable to the carrying of foreclosure property under paragraph (b) of this section, the following rules apply:

(1) *Deductible interest.* Interest is taken into account under this paragraph (e) only if it is otherwise deductible under chapter 1 of the Code.

(2) *Interest specifically allocated to property.* Interest that is specifically allocated to an item of property is attributable only to the carrying of that property. Interest is specifically allocated to an item of property if (i) the indebtedness on which the interest is paid or accrued is secured only by that property, (ii) such indebtedness was specifically incurred for the purpose of purchasing, constructing, maintaining, or improving that property, and (iii) the proceeds of the borrowing were applied for that purpose.

(3) *Other interest.* Interest which is not specifically allocated to property is apportioned between foreclosure property and other property under the principles of § 1.861–8(e)(2)(v).

(4) *Effective date.* The rules in this paragraph (e) are mandatory for all taxable years ending after February 6, 1981.

(Sec. 856(d)(4) (90 Stat. 1750; 26 U.S.C. 856(d)(4)); sec. 856(e)(5) (88 Stat. 2113; 26 U.S.C. 856(e)(5)); sec. 856(f)(2) (90 Stat. 1751; 26 U.S.C. (856(f)(2)); sec. 856(g)(2) (90 Stat. 1753; 26 U.S.C. 856(g)(2)); sec. 858(a) (74 Stat. 1008; 26 U.S.C. 858(a)); sec. 859(c) (90 Stat. 1743; 26 U.S.C. 859(c)); sec. 859(e) (90 Stat. 1744; 26 U.S.C. 859(e)); sec. 6001 (68A Stat. 731; 26 U.S.C. 6001); sec. 6011 (68A Stat. 732; 26 U.S.C. 6011); sec. 6071 (68A Stat. 749, 26 U.S.C. 6071); sec. 6091 (68A Stat. 752; 26 U.S.C. 6091); sec. 7805 (68A Stat. 917; 26 U.S.C. 7805), Internal Revenue Code of 1954))

[T.D. 7767, 46 FR 11277, Feb. 6, 1981]

§ 1.857–4 Tax imposed by reason of the failure to meet certain source-of-income requirements.

Section 857(b)(5) imposes a tax on a real estate investment trust that is considered, by reason of section 856(c)(7), as meeting the source-of-income requirements of paragraph (2) or (3) of section 856(c) (or both such paragraphs). The amount of the tax is determined in the manner prescribed in section 857(b)(5).

(Sec. 856(d)(4) (90 Stat. 1750; 26 U.S.C. 856(d)(4)); sec. 856(e)(5) (88 Stat. 2113; 26 U.S.C. 856(e)(5)); sec. 856(f)(2) (90 Stat. 1751; 26 U.S.C. (856(f)(2)); sec. 856(g)(2) (90 Stat. 1753; 26 U.S.C. 856(g)(2)); sec. 858(a) (74 Stat. 1008; 26 U.S.C. 858(a)); sec. 859(c) (90 Stat. 1743; 26 U.S.C. 859(c)); sec. 859(e) (90 Stat. 1744; 26 U.S.C. 859(e)); sec. 6001 (68A Stat. 731; 26 U.S.C. 6001); sec. 6011 (68A Stat. 732; 26 U.S.C. 6011); sec. 6071 (68A Stat. 749, 26 U.S.C. 6071); sec. 6091 (68A Stat. 752; 26 U.S.C. 6091); sec. 7805 (68A Stat. 917; 26 U.S.C. 7805), Internal Revenue Code of 1954))

[T.D. 7767, 46 FR 11278, Feb. 2, 1981]

§ 1.857–5 Net income and loss from prohibited transactions.

(a) *In general.* Section 857(b)(6) imposes, for each taxable year, a tax equal to 100 percent of the net income derived from prohibited transactions. A prohibited transaction is a sale or other disposition of property described in section 1221(1) that is not foreclosure property. The 100-percent tax is imposed to preclude a real estate investment trust from retaining any profit from ordinary retailing activities such as sales to customers of condominium units or subdivided lots in a development tract. In order to prevent a trust from receiving any tax benefit from such activities, a net loss from prohibited transactions effectively is disallowed in compting real estate investment trust taxable income. See § 1.857–2(a)(8). Such loss, however, does reduce the amount which a trust is required to distribute as dividends. For purposes of applying the provisions of the Code, other than those provisions of part II of subchapter M which relate to prohibited transactions, no inference is to be drawn from the fact that a type of transaction does not constitute a prohibited transaction.

(b) *Special rules.* In determining whether a particular transaction constitutes a prohibited transaction, the activities of a real estate investment trust with respect to foreclosure property and its sales of such property are disregarded. Also, if a real estate investment trust enters into a purchase and leaseback of real property with an option in the seller-lessee to repurchase the property at the end of the lease period, and the seller exercises

the option pursuant to its terms, income from the sale generally will not be considered to be income from a prohibited transaction solely because the purchase and leaseback was entered into with an option in the seller to repurchase and because the option was exercised pursuant to its terms. Other facts and circumstances, however, may require a conclusion that the property is held primarily for sale to customers in the ordinary course of a trade or business. Gain from the sale or other disposition of property described in section 1221(1) (other than foreclosure property) that is included in gross income for a taxable year of a qualified real estate investment trust constitutes income from a prohibited transaction, even though the sale or other disposition from which the gain is derived occurred in a prior taxable year. For example, if a corporation that is a qualified real estate investment trust for the current taxable year elected to report the income from the sale of an item of section 1221(1) property (other than foreclosure property) on the installment method of reporting income, the gain from the sale that is taken into income by the real estate investment trust for the current taxable year is income from a prohibited transaction. This result follows even though the sale occurred in a prior taxable year for which the corporation did not qualify as a real estate investment trust. On the other hand, if the gain is taken into income in a taxable year for which the taxpayer is not a qualifed real estate investment trust, the 100-percent tax does not apply.

(c) *Net income or loss from prohibited transactions.* Net income or net loss from prohibited transactions is determined by aggregating all gains from the sale or other disposition of property (other than foreclosure property) described in section 1221(1) with all losses from the sale or other disposition of such property. Thus, for example, if a real estate investment trust sells two items of property described in section 1221(1) (other than foreclosure property) and recognizes a gain of $100 on the sale of one item and a loss of $40 on the sale of the second item, the net income from prohibited transactions will be $60.

(Sec. 856(d)(4) (90 Stat. 1750; 26 U.S.C. 856(d)(4)); sec. 856(e)(5) (88 Stat. 2113; 26 U.S.C. 856(e)(5)); sec. 856(f)(2) (90 Stat. 1751; 26 U.S.C. (856(f)(2)); sec. 856(g)(2) (90 Stat. 1753; 26 U.S.C. 856(g)(2)); sec. 858(a) (74 Stat. 1008; 26 U.S.C. 858(a)); sec. 859(c) (90 Stat. 1743; 26 U.S.C. 859(c)); sec. 859(e) (90 Stat. 1744; 26 U.S.C. 859(e)); sec. 6001 (68A Stat. 731; 26 U.S.C. 6001); sec. 6011 (68A Stat. 732; 26 U.S.C. 6011); sec. 6071 (68A Stat. 749, 26 U.S.C. 6071); sec. 6091 (68A Stat. 752; 26 U.S.C. 6091); sec. 7805 (68A Stat. 917; 26 U.S.C. 7805), Internal Revenue Code of 1954))

[T.D. 7767, 46 FR 11278, Feb. 6, 1981]

§ 1.857–6 Method of taxation of shareholders of real estate investment trusts.

(a) *Ordinary income.* Except as otherwise provided in paragraph (b) of this section (relating to capital gains), a shareholder receiving dividends from a real estate investment trust shall include such dividends in gross income for the taxable year in which they are received. See section 858(b) and paragraph (c) of § 1.858–1 for treatment by shareholders of dividends paid by a real estate investment trust after the close of its taxable year in the case of an election under section 858(a).

(b) *Capital gains.* Under section 857(b)(3)(B), shareholders of a real estate investment trust who receive capital gain dividends (as defined in paragraph (e) of this section), in respect of the capital gains of a corporation, trust, or association for a taxable year for which it is taxable under part II of subchapter M as a real estate investment trust, shall treat such capital gain dividends as gains from the sale or exchange of capital assets held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) and realized in the taxable year of the shareholder in which the dividend was received. In the case of dividends with respect to any taxable year of a real estate investment trust ending after December 31, 1969, and beginning before January 1, 1975, the portion of a shareholder's capital gain dividend which in his hands is gain to which section 1201(d) (1) or (2) applies is the portion

so designated by the real estate investment trust pursuant to paragraph (e)(2) of this section.

(c) *Special treatment of loss on the sale or exchange of real estate investment trust stock held less than 31 days*—(1) *In general.* Under section 857(b)(7), if any person with respect to a share of real estate investment trust stock held for a period of less than 31 days, is required by section 857(b)(3)(B) to include in gross income as a gain from the sale or exchange of a capital asset held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) the amount of a capital gains dividend, then such person shall, to the extent of such amount, treat any loss on the sale or exchange of such share as a loss from the sale or exchange of a capital asset held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977).

(2) *Determination of holding period.* The rules contained in section 246(c)(3) (relating to the determination of holding periods for purposes of the deduction for dividends received) shall be applied in determining whether, for purposes of section 857(b)(7)(B) and this paragraph, a share of real estate investment trust stock has been held for a period of less than 31 days. In applying those rules, however, ''30 days'' shall be substituted for the number of days specified in subparagraph (B) of such section.

(3) *Illustration.* The application of section 857(b)(7) and this paragraph may be illustrated by the following example:

Example. On December 15, 1961, A purchased a share of stock in the S Real Estate Investment Trust for $20. The S trust declared a capital gains dividend of $2 per share to shareholders of record on December 31, 1961. A, therefore, received a capital gain dividend of $2 which, pursuant to section 857(b)(3)(B), he must treat as a gain from the sale or exchange of a capital asset held for more than six months. On January 5, 1962, A sold his share of stock in the S trust for $17.50, which sale resulted in a loss of $2.50. Under section 857(b)(4) and this paragraph, A must treat $2 of such loss (an amount equal to the capital gain dividend received with respect to such share of stock) as a loss from the sale or exchange of a capital asset held for more than six months.

(d) *Dividend received credit, exclusion, and deduction not allowed.* Any dividend received from a real estate investment trust which, for the taxable year to which the dividend relates, is a qualified real estate investment trust, shall not be eligible for the dividend received credit (for dividends received on or before December 31, 1964) under section 34(a), the dividend received exclusion under section 116, or the dividend received deduction under section 243.

(e) *Definition of capital gain dividend.* (1)(i) A capital gain dividend, as defined in section 857(b)(3)(C), is any dividend or part thereof which is designated by a real estate investment trust as a capital gain dividend in a written notice mailed to its shareholders within the period specified in section 857(b)(3)(C) and paragraph (f) of this section. If the aggregate amount so designated with respect to the taxable year (including capital gain dividends paid after the close of the taxable year pursuant to an election under section 858) is greater than the net capital gain of the taxable year, the portion of each distribution which shall be a capital gain dividend shall be only that proportion of the amount so designated which such excess of the net long-term capital gain over the net short-term capital loss bears to the aggregate of the amount so designated. For example, a real estate investment trust making its return on the calendar year basis advised its shareholders by written notice mailed December 30, 1961, that $200,000 of a distribution of $500,000 made December 15, 1961, constituted a capital gain dividend, amounting to $2 per share. It was later discovered that an error had been made in determining the net capital gain of the taxable year and the net capital gain was $100,000 instead of $200,000. In such case, each shareholder would have received a capital gain dividend of $1 per share instead of $2 per share.

(ii) For purposes of section 857(b)(3)(C) and this paragraph, the net capital gain for a taxable year ending after October 4, 1976, is deemed not to exceed the real estate investment trust taxable income determined by taking into account the net operating loss deduction for the taxable year but not

the deduction for dividends paid. See example 2 in § 1.172–5(a)(4).

(2) In the case of capital gain dividends designated with respect to any taxable year of a real estate investment trust ending after December 31, 1969, and beginning before January 1, 1975 (including capital gain dividends paid after the close of the taxable year pursuant to an election under section 858), the real estate investment trust must include in its written notice designating the capital gain dividend a statement showing the shareholder's proportionate share of such dividend which is gain described in section 1201(d)(1) and his proportionate share of such dividend which is gain described in section 1201(d)(2). In determining the portion of the capital gain dividend which, in the hands of a shareholder, is gain described in section 1201(d) (1) or (2), the real estate investment trust shall consider that capital gain dividends for a taxable year are first made from its long-term capital gains which are not described in section 1201(d) (1) or (2), to the extent thereof, and then from its long-term capital gains for such year which are described in section 1201(d) (1) or (2). A shareholder's proportionate share of gains which are described in section 1201(d)(1) is the amount which bears the same ratio to the amount paid to him as a capital gain dividend in respect of such year as (i) the aggregate amount of the trust's gains which are described in section 1201(d)(1) and paid to all shareholders bears to (ii) the aggregate amount of the capital gain dividend paid to all shareholders in respect of such year. A shareholder's proportionate share of gains which are described in section 1201(d)(2) shall be determined in a similar manner. Every real estate investment trust shall keep a record of the proportion of each capital gain divided (to which this subparagraph applies) which is gain described in section 1201(d) (1) or (2).

(f) *Mailing of written notice to shareholders*—(1) *General rule*. Except as provided in paragraph (f)(2) of this section, the written notice designating a dividend or part thereof as a capital gain dividend must be mailed to the shareholders not later than 30 days after the close of the taxable year of the real estate investment trust.

(2) *Net capital gain resulting from a determination*. If, as a result of a determination (as defined in section 860(e)), occurring after October 4, 1976, there is an increase in the amount by which the net capital gain exceeds the deduction for dividends paid (determined with reference to capital gains dividends only) for the taxable year, then a real estate investment trust may designate a dividend (or part thereof) as a capital gain dividend in a written notice mailed to its shareholders at any time during the 120-day period immediately following the date of the determination. The designation may be made with respect to a dividend (or part thereof) paid during the taxable year to which the determination applies (including a dividend considered as paid during the taxable year pursuant to section 858). A deficiency dividend (as defined in section 860(f)), or a part thereof, that is paid with respect to the taxable year also may be designated as a capital gain dividend by the real estate investment trust (or by the acquiring corporation to which section 381(c)(25) applies) before the expiration of the 120-day period immediately following the determination. However, the aggregate amount of the dividends (or parts thereof) that may be designated as capital gain dividends after the date of the determination shall not exceed the amount of the increase in the excess of the net capital gain over the deduction for dividends paid (determined with reference to capital gains dividends only) that results from the

determination. The date of a determination shall be established in accordance with § 1.860–2(b)(1).

(Sec. 856(d)(4) (90 Stat. 1750; 26 U.S.C. 856(d)(4)); sec. 856(e)(5) (88 Stat. 2113; 26 U.S.C. 856(e)(5)); sec. 856(f)(2) (90 Stat. 1751; 26 U.S.C. (856(f)(2)); sec. 856(g)(2) (90 Stat. 1753; 26 U.S.C. 856(g)(2)); sec. 858(a) (74 Stat. 1008; 26 U.S.C. 858(a)); sec. 859(c) (90 Stat. 1743; 26 U.S.C. 859(c)); sec. 859(e) (90 Stat. 1744; 26 U.S.C. 859(e)); sec. 6001 (68A Stat. 731; 26 U.S.C. 6001); sec. 6011 (68A Stat. 732; 26 U.S.C. 6011); sec. 6071 (68A Stat. 749, 26 U.S.C. 6071); sec. 6091 (68A Stat. 752; 26 U.S.C. 6091); sec. 7805 (68A Stat. 917; 26 U.S.C. 7805), Internal Revenue Code of 1954); sec. 860(e) (92 Stat. 2849, 26 U.S.C. 860(e)); sec. 860(g) (92 Stat. 2850, 26 U.S.C. 860(g)))

[T.D. 6598, 27 FR 4088, Apr. 28, 1962, as amended by T.D. 6777, 29 FR 17809, Dec. 16, 1964; T.D. 7337, 39 FR 44974, Dec. 30, 1974; T.D. 7728, 45 FR 72650, Nov. 3, 1980. Redesignated and amended by T.D. 7767, 46 FR 11277, 11279, 11283, Feb. 6, 1981; T.D. 7936, 49 FR 2107, Jan. 18, 1984; T.D. 8107, 51 FR 43347, Dec. 2, 1986]

§ 1.857–7 Earnings and profits of a real estate investment trust.

(a) Any real estate investment trust whether or not such trust meets the requirements of section 857(a) and paragraph (a) of § 1.857–1 for any taxable year beginning after December 31, 1960 shall apply paragraph (b) of this section in computing its earnings and profits for such taxable year.

(b) In the determination of the earnings and profits of a real estate investment trust, section 857(d) provides that such earnings and profits for any taxable year (but not the accumulated earnings and profits) shall not be reduced by any amount which is not allowable as a deduction in computing its taxable income for the taxable year. Thus, if a trust would have had earnings and profits of $500,000 for the taxable year except for the fact that it had a net capital loss of $100,000, which amount was not deductible in determining its taxable income, its earnings and profits for that year if it is a real estate investment trust would be $500,000. If the real estate investment trust had no accumulated earnings and profits at the beginning of the taxable year, in determining its accumulated earnings and profits as of the beginning of the following taxable year, the earnings and profits for the taxable year to be considered in such computation would amount to $400,000 assuming that there had been no distribution from such earnings and profits. If distributions had been made in the taxable year in the amount of the earnings and profits then available for distribution, $500,000, the trust would have as of the beginning of the following taxable year neither accumulated earnings and profits nor a deficit in accumulated earnings and profits, and would begin such year with its paid-in capital reduced by $100,000, an amount equal to the excess of the $500,000 distributed over the $400,000 accumulated earnings and profits which would otherwise have been carried into the following taxable year. For purposes of section 857(d) and this section, if an amount equal to any net loss derived from prohibited transactions is included in real estate investment trust taxable income pursuant to section 857(b)(2)(F), that amount shall be considered to be an amount which is not allowable as a deduction in computing taxable income for the taxable year. The earnings and profits for the taxable year (but not the accumulated earnings and profits) shall not be considered to be less than (i) in the case of a taxable year ending before October 5, 1976, the amount (if any) of the net capital gain for the taxable year, or (ii) in the case of a taxable year ending after December 31, 1973, the amount (if any), of the excess of the net income from foreclosure property for the taxable year over the tax imposed thereon by section 857(b)(4)(A).

(Sec. 856(d)(4) (90 Stat. 1750; 26 U.S.C. 856(d)(4)); sec. 856(e)(5) (88 Stat. 2113; 26 U.S.C. 856(e)(5)); sec. 856(f)(2) (90 Stat. 1751; 26 U.S.C. (856(f)(2)); sec. 856(g)(2) (90 Stat. 1753; 26 U.S.C. 856(g)(2)); sec. 858(a) (74 Stat. 1008; 26 U.S.C. 858(a)); sec. 859(c) (90 Stat. 1743; 26 U.S.C. 859(c)); sec. 859(e) (90 Stat. 1744; 26 U.S.C. 859(e)); sec. 6001 (68A Stat. 731; 26 U.S.C. 6001); sec. 6011 (68A Stat. 732; 26 U.S.C. 6011); sec. 6071 (68A Stat. 749, 26 U.S.C. 6071); sec. 6091 (68A Stat. 752; 26 U.S.C. 6091); sec. 7805 (68A Stat. 917; 26 U.S.C. 7805), Internal Revenue Code of 1954))

[T.D. 6598, 27 FR 4088, Apr. 28, 1962. Redesignated and amended by T.D. 7767, 46 FR 11277, 11279, Feb. 6, 1981]

§ 1.857–8 Records to be kept by a real estate investment trust.

(a) *In general.* Under section 857(a)(2) a real estate investment trust is required to keep such records as will disclose the actual ownership of its outstanding stock. Thus, every real estate investment trust shall maintain in the internal revenue district in which it is required to file its income tax return permanent records showing the information relative to the actual owners of its stock contained in the written statements required by this section to be demanded from its shareholders. Such records shall be kept at all times available for inspection by any internal revenue officer or employee, and shall be retained so long as the contents thereof may become material in the administration of any internal revenue law.

(b) *Actual owner of stock.* The actual owner of stock of a real estate investment trust is the person who is required to include in gross income in his return the dividends received on the stock. Generally, such person is the shareholder of record of the real estate investment trust. However, where the shareholder of record is not the actual owner of the stock, the stockholding record of the real estate investment trust may not disclose the actual ownership of such stock. Accordingly, the real estate investment trust shall demand written statements from shareholders of record disclosing the actual owners of stock as required in paragraph (d) of this section.

(c) *Stock ownership for personal holding company determination.* For the purpose of determining under section 856(a)(6) whether a trust, claiming to be a real estate investment trust, is a personal holding company, the permanent records of the trust shall show the maximum number of shares of the trust (including the number and face value of securities convertible into stock of the trust) to be considered as actually or constructively owned by each of the actual owners of any of its stock at any time during the last half of the trust's taxable year, as provided in section 544.

(d) *Statements to be demanded from shareholders.* The information required by paragraphs (b) and (c) of this section shall be set forth in written statements which shall be demanded from shareholders of record as follows:

(1) In the case of a trust having 2,000 or more shareholders of record of its stock on any dividend record date, from each record holder of 5 percent or more of its stock; or

(2) In the case of a trust having less than 2,000 and more than 200 shareholders of record of its stock on any dividend record date, from each record holder of 1 percent or more of its stock; or

(3) In the case of a trust having 200 or less shareholders of record of its stock on any dividend record date, from each record holder of one-half of 1 percent or more of its stock.

(e) *Demands for statements.* The written statements from shareholders of record shall be demanded by the real estate investment trust in accordance with paragraph (d) of this section within 30 days after the close of the real estate investment trust's taxable year (or before June 1, 1962, whichever is later). When making demand for such written statements, the trust shall inform each such shareholder of his duty to submit at the time he files his income tax return (or before July 1, 1962, whichever is later) the statements which are required by § 1.857–9 if he fails or refuses to comply with such demand. A list of the persons failing or refusing to comply in whole or in part with the trust's demand for statements under this section shall be maintained as a part of the trust's records required by this section. A trust which fails to keep such records to show, to the extent required by this section, the actual ownership of its outstanding stock

shall be taxable as an ordinary corporation and not as a real estate investment trust.

(Sec. 856(d)(4) (90 Stat. 1750; 26 U.S.C. 856(d)(4)); sec. 856(e)(5) (88 Stat. 2113; 26 U.S.C. 856(e)(5)); sec. 856(f)(2) (90 Stat. 1751; 26 U.S.C. (856(f)(2)); sec. 856(g)(2) (90 Stat. 1753; 26 U.S.C. 856(g)(2)); sec. 858(a) (74 Stat. 1008; 26 U.S.C. 858(a)); sec. 859(c) (90 Stat. 1743; 26 U.S.C. 859(c)); sec. 859(e) (90 Stat. 1744; 26 U.S.C. 859(e)); sec. 6001 (68A Stat. 731; 26 U.S.C. 6001); sec. 6011 (68A Stat. 732; 26 U.S.C. 6011); sec. 6071 (68A Stat. 749, 26 U.S.C. 6071); sec. 6091 (68A Stat. 752; 26 U.S.C. 6091); sec. 7805 (68A Stat. 917; 26 U.S.C. 7805), Internal Revenue Code of 1954))

[T.D. 6598, 27 FR 4088, Apr. 28, 1962. Redesignated and amended by T.D. 7767, 46 FR 11277, 11279, Feb. 6, 1981]

§ 1.857–9 Information required in returns of shareholders.

(a) *In general.* Any person who fails or refuses to submit to a real estate investment trust the written statements required under § 1.857–8 to be demanded by such trust from its shareholders of record shall submit at the time he files his income tax return for his taxable year which ends with, or includes, the last day of the trust's taxable year (or before July 1, 1962, whichever is later) a statement setting forth the information required by this section.

(b) *Information required*—(1) *Shareholder of record not actual owner.* In the case of any person holding shares of stock in any trust claiming to be a real estate investment trust who is not the actual owner of such stock, the name and address of each actual owner, the number of shares owned by each actual owner at any time during such person's taxable year, and the amount of dividends belonging to each actual owner.

(2) *Actual owner of shares.* In the case of an actual owner of shares of stock in any trust claiming to be a real estate investment trust—

(i) The name and address of each such trust, the number of shares actually owned by him at any and all times during his taxable year, and the amount of dividends from each such trust received during his taxable year;

(ii) If shares of any such trust were acquired or disposed of during such person's taxable year, the name and address of the trust, the number of shares acquired or disposed of, the dates of acquisition or disposition, and the names and addresses of the persons from whom such shares were acquired or to whom they were transferred;

(iii) If any shares of stock (including securities convertible into stock) of any such trust are also owned by any member of such person's family (as defined in section 544(a)(2)), or by any of his partners, the name and address of the trust, the names and addresses of such members of his family and his partners, and the number of shares owned by each such member of his family or partner at any and all times during such person's taxable year; and

(iv) The names and addresses of any corporation, partnership, association, or trust, in which such person had a beneficial interest of 10 percent or more at any time during his taxable year.

(Sec. 856(d)(4) (90 Stat. 1750; 26 U.S.C. 856(d)(4)); sec. 856(e)(5) (88 Stat. 2113; 26 U.S.C. 856(e)(5)); sec. 856(f)(2) (90 Stat. 1751; 26 U.S.C. (856(f)(2)); sec. 856(g)(2) (90 Stat. 1753; 26 U.S.C. 856(g)(2)); sec. 858(a) (74 Stat. 1008; 26 U.S.C. 858(a)); sec. 859(c) (90 Stat. 1743; 26 U.S.C. 859(c)); sec. 859(e) (90 Stat. 1744; 26 U.S.C. 859(e)); sec. 6001 (68A Stat. 731; 26 U.S.C. 6001); sec. 6011 (68A Stat. 732; 26 U.S.C. 6011); sec. 6071 (68A Stat. 749, 26 U.S.C. 6071); sec. 6091 (68A Stat. 752; 26 U.S.C. 6091); sec. 7805 (68A Stat. 917; 26 U.S.C. 7805), Internal Revenue Code of 1954))

[T.D. 6598, 27 FR 4089, Apr. 28, 1962, as amended by T.D. 6628, 27 FR 12794, Dec. 28, 1962. Redesignated and amended by T.D. 7767, 46 FR 11277, 11279, Feb. 6, 1981]

§ 1.857–10 Information returns.

Nothing in §§ 1.857–8 and 1.857–9 shall be construed to relieve a real estate investment trust or its shareholders from the duty of filing information returns required by regulations prescribed

under the provisions of subchapter A, chapter 61 of the Code.

(Sec. 856(d)(4) (90 Stat. 1750; 26 U.S.C. 856(d)(4)); sec. 856(e)(5) (88 Stat. 2113; 26 U.S.C. 856(e)(5)); sec. 856(f)(2) (90 Stat. 1751; 26 U.S.C. (856(f)(2)); sec. 856(g)(2) (90 Stat. 1753; 26 U.S.C. 856(g)(2)); sec. 858(a) (74 Stat. 1008; 26 U.S.C. 858(a)); sec. 859(c) (90 Stat. 1743; 26 U.S.C. 859(c)); sec. 859(e) (90 Stat. 1744; 26 U.S.C. 859(e)); sec. 6001 (68A Stat. 731; 26 U.S.C. 6001); sec. 6011 (68A Stat. 732; 26 U.S.C. 6011); sec. 6071 (68A Stat. 749, 26 U.S.C. 6071); sec. 6091 (68A Stat. 752; 26 U.S.C. 6091); sec. 7805 (68A Stat. 917; 26 U.S.C. 7805), Internal Revenue Code of 1954))

[T.D. 6598, 27 FR 4089, Apr. 28, 1962. Redesignated and amended by T.D. 7767, 46 FR 11277, 11279, Feb. 6, 1981]

§ 1.857–11 Non-REIT earnings and profits.

(a) *Applicability of section 857(a)(3)(A).* A real estate investment trust does not satisfy section 857(a)(3)(A) unless—

(1) Part II of subchapter M applied to the trust for all its taxable years beginning after February 28, 1986; and

(2) For each corporation to whose earnings and profits the trust succeeded by the operation of section 381, part II of subchapter M applied for all the corporation's taxable years beginning after February 28, 1986.

(b) *Applicability of section 857(a)(3)(B); in general.* A real estate investment trust does not satisfy section 857(a)(3)(B) unless, as of the close of the taxable year, it has no earnings and profits other than earnings and profits that—

(1) Were earned by a corporation in a year for which part II of subchapter M applied to the corporation and, at all times thereafter, were the earnings and profits of a corporation to which part II of subchapter M applied; or

(2) By the operation of section 381 pursuant to a transaction that occurred before December 22, 1992, became the earnings and profits of a corporation to which part II of subchapter M applied and, at all times thereafter, were the earnings and profits of a corporation to which part II of subchapter M applied.

(c) *Distribution procedures similar to those for regulated investment companies to apply.* Distribution procedures similar to those in section 852(e) for regulated investment companies apply to non-REIT earnings and profits of real estate investment trusts.

(d) *Effective date.* This regulation is effective for taxable years ending on or after December 22, 1992.

(e) For treatment of net built-in gain assets of a C corporation that become assets of a REIT, see § 1.337(d)–5T.

[T.D. 8483, 58 FR 43798, Aug. 18, 1993, as amended by T.D. 8872, 65 FR 5777, Feb. 7, 2000]

§ 1.858–1 Dividends paid by a real estate investment trust after close of taxable year.

(a) *General rule.* Under section 858, a real estate investment trust may elect to treat certain dividends that are distributed within a specified period after the close of a taxable year as having been paid during the taxable year. The dividend is taken into account in determining the deduction for dividends paid for the taxable year in which it is treated as paid. The dividend may be an ordinary dividend or, subject to the requirements of sections 857(b)(3)(C) and 858(c), a capital gain dividend. The trust may make the dividend declaration required by section 858(a)(1) either before or after the close of the taxable year as long as the declaration is made before the time prescribed by law for filing its return for the taxable year (including the period of any extension of time granted for filing the return).

(b) *Election*—(1) *Method of making election.* The election must be made in the return filed by the trust for the taxable year. The election shall be made by treating the dividend (or portion thereof) to which the election applies as a dividend paid during the taxable year of the trust in computing its real estate investment trust taxable income and, if applicable, the alternative tax imposed by section 857(b)(3)(A). (In the case of an election with respect to a taxable year ending before October 5, 1976, if the dividend (or portion thereof) to which the election is to apply is a capital gain dividend, the trust shall treat the dividend as paid during such taxable year in computing the amount of capital gains dividends paid during the taxable year.) In the case of an election with respect to a taxable year beginning after October 4, 1976, the trust must also specify in its return (or in a statement attached to its return)

the exact dollar amount that is to be treated as having been paid during the taxable year.

(2) *Limitation based on earnings and profits.* The election provided in section 858(a) may be made only to the extent that the earnings and profits of the taxable year (computed with the application of sections 857(d) and §1.857–7) exceed the total amount of distributions out of such earnings and profits actually made during the taxable year. For purposes of the preceding sentence, deficiency dividends and distributions with respect to which an election has been made for a prior year under section 858(a) are disregarded in determining the total amount of distributions out of earnings and profits actually made during the taxable year. The dividend or portion thereof, with respect to which the real estate investment trust has made a valid election under section 858(a), shall be considered as paid out of the earnings and profits of the taxable year for which such election is made, and not out of the earnings and profits of the taxable year in which the distribution is actually made.

(3) *Additional limitation based on amount specified.* The amount treated under section 858(a) as having been paid in a taxable year beginning after October 4, 1976, cannot exceed the lesser of (i) the dollar amount specified by the trust in its return (or a statement attached thereto) in making the election or (ii) the amount allowable under the limitation prescribed in paragraph (b)(2) of this section.

(4) *Irrevocability of the election.* After the expiration of the time for filing the return for the taxable year for which an election is made under section 858(a), such election shall be irrevocable with respect to the dividend or portion thereof to which it applies.

(c) *Receipt by shareholders.* Under section 858(b), the dividend or portion thereof, with respect to which a valid election has been made, will be includable in the gross income of the shareholders of the real estate investment trust for the taxable year in which the dividend is received by them.

(d) *Illustrations.* The application of paragraphs (a), (b), and (c) of this section may be illustrated by the following examples:

Example 1. The X Trust, a real estate investment trust, had taxable income (and earnings and profits) for the calendar year 1961 of $100,000. During that year the trust distributed to shareholders taxable dividends aggregating $88,000. On March 10, 1962, the trust declared a dividend of $37,000 payable to shareholders on March 20, 1962. Such dividend consisted of the first regular quarterly dividend for 1962 of $25,000 plus an additional $12,000 representing that part of the taxable income for 1961 which was not distributed in 1961. On March 15, 1962, the X Trust filed its Federal income tax return and elected therein to treat $12,000 of the total dividend of $37,000 to be paid to shareholders on March 20, 1962, as having been paid during the taxable year 1961. Assuming that the X Trust actually distributed the entire amount of the dividend of $37,000 on March 20, 1962, an amount equal to $12,000 thereof will be treated for the purposes of section 857(a) as having been paid during the taxable year 1961. Upon distribution of such dividend the trust becomes a qualified real estate investment trust for the taxable year 1961. Such amount ($12,000) will be considered by the X Trust as a distribution out of the earnings and profits for the taxable year 1961, and will be treated by the shareholders as a taxable dividend for the taxable year in which such distribution is received by them. However, assuming that the X Trust is not a qualified real estate investment trust for the calendar year 1962, nevertheless, the $12,000 portion of the dividend (paid on March 20, 1962) which the trust elected to relate to the calendar year 1961, will not qualify as a dividend for purposes of section 34, 116, or 243.

Example 2. The Y Trust, a real estate investment trust, had taxable income (and earnings and profits) for the calendar year 1964 of $100,000, and for 1965 taxable income (and earnings and profits) of $125,000. On January 1, 1964, the trust had a deficit in its earnings and profits accumulated since February 28, 1913, of $115,000. During the year 1964 the trust distributed to shareholders taxable dividends aggregating $85,000. On March 5, 1965, the trust declared a dividend of $65,000 payable to shareholders on March 31, 1965. On March 15, 1965, the Y Trust filed its Federal income tax return in which it included $40,000 of the total dividend of $65,000 payable to shareholders on March 31, 1965, as a dividend paid by it during the taxable year 1964. On March 31, 1965, the Y Trust distributed the entire amount of the dividend of $65,000 declared on March 5, 1965. The election under section 858(a) is valid only to the extent of $15,000, the amount of the undistributed earnings and profits for 1964 ($100,000 earnings and profits less $85,000 distributed during 1964). The remainder ($50,000) of the

$65,000 dividend paid on March 31, 1965, could not be the subject of an election, and such amount will be regarded as a distribution by the Y Trust out of earnings and profits for the taxable year 1965. Assuming that the only other distribution by the Y Trust during 1965 was a distribution of $75,000 paid as a dividend on October 31, 1965, the total amount of the distribution of $65,000 paid on March 31, 1965, is to be treated by the shareholders as taxable dividends for the taxable year in which such dividend is received. The Y Trust will treat the amount of $15,000 as a distribution of the earnings or profits of the trust for the taxable year 1964, and the remaining $50,000 as a distribution of the earnings or profits for the year 1965. The distribution of $75,000 on October 31, 1966, is, of course, a taxable dividend out of the earnings and profits for the year 1965.

Example 3. Assume the facts are the same as in example 2, except that the taxable years involved are calendar years 1977 and 1978, and Y Trust specified in its Federal income tax return for 1977 that the dollar amount of $40,000 of the $65,000 distribution payable to shareholders on March 31, 1978, is to be treated as having been paid in 1977. The result will be the same as in example 2, since the amount of the undistributed earnings and profits for 1977 is less than the $40,000 amount specified by Y Trust in making its election. Accordingly, the election is valid only to the extent of $15,000. Y Trust will treat the amount of $15,000 as a distribution, in 1977, of earnings and profits of the trust for the taxable year 1977 and the remaining $50,000 as a distribution, in 1978, of the earnings and profits for 1978.

(e) *Notice to shareholders.* Section 858(c) provides that, in the case of dividends with respect to which a real estate investment trust has made an election under section 858(a), any notice to shareholders required under part II, subchapter M, chapter 1 of the Code, with respect to such amounts, shall be made not later than 30 days after the close of the taxable year in which the distribution is made. Thus, the notice requirement of section 857(b)(3)(C) and paragraph (f) of § 1.857–6 with respect to capital gains dividends may be satisfied with respect to amounts to which section 858(a) and this section apply if the notice relating to such amounts is mailed to the shareholders not later than 30 days after the close of the taxable year in which the distribution is made. If the notice under section 858(c) reltes to an election with respect to any capital gains dividends, such capital gains dividends shall be aggregated by the real estate investment trust with the designated capital gains dividends actually paid during the taxable year to which the election applies (not including deficiency dividends or dividends with respect to which an election has been made for a prior taxable year under section 858) to determine whether the aggregate of the designated capital gains dividends with respect to such taxable year exceeds the net capital gain of the trust. See section 857(b)(3)(C) and paragraph (f) of § 1.857–6.

(Sec. 856(d)(4) (90 Stat. 1750; 26 U.S.C. 856(d)(4)); sec. 856(e)(5) (88 Stat. 2113; 26 U.S.C. 856(e)(5)); sec. 856(f)(2) (90 Stat. 1751; 26 U.S.C. (856(f)(2)); sec. 856(g)(2) (90 Stat. 1753; 26 U.S.C. 856(g)(2)); sec. 858(a) (74 Stat. 1008; 26 U.S.C. 858(a)); sec. 859(c) (90 Stat. 1743; 26 U.S.C. 859(c)); sec. 859(e) (90 Stat. 1744; 26 U.S.C. 859(e)); sec. 6001 (68A Stat. 731; 26 U.S.C. 6001); sec. 6011 (68A Stat. 732; 26 U.S.C. 6011); sec. 6071 (68A Stat. 749, 26 U.S.C. 6071); sec. 6091 (68A Stat. 752; 26 U.S.C. 6091); sec. 7805 (68A Stat. 917; 26 U.S.C. 7805), Internal Revenue Code of 1954))

[T.D. 6598, 27 FR 4089, Apr. 28, 1962, as amended by T.D. 7767, 46 FR 11279, Feb. 6, 1981]

§ 1.860–1 Deficiency dividends.

Section 860 allows a qualified investment entity to be relieved from the payment of a deficiency in (or to be allowed a credit or refund of) certain taxes. ''Qualified investment entity'' is defined in section 860(b). The taxes referred to are those imposed by sections 852(b) (1) and (3), 857(b) (1) or (3), the minimum tax on tax preferences imposed by section 56 and, if the entity fails the distribution requirements of section 852(a)(1)(A) or 857(a)(1) (as applicable), the corporate income tax imposed by section 11(a) or 1201(a). The method provided by section 860 is to allow an additional deduction for a dividend distribution (that meets the requirements of section 860 and § 1.860–2) in computing the deduction for dividends paid for the taxable year for which the deficiency is determined. A deficiency divided may be an ordinary dividend or, subject to the limitations of sections 852(b)(3)(C), 857(b)(3)(C), and

860(f)(2)(B), may be a capital gain dividend.

(Sec. 7805, 68A Stat. 917; 26 U.S.C. 7805; sec. 860(e) (92 Stat. 2849, 26 U.S.C. 860(e)); sec. 860(g) (92 Stat. 2850, 26 U.S.C. 860(g)))

[T.D. 7936, 49 FR 2107, Jan. 18, 1984]

§ 1.860–2 Requirements for deficiency dividends.

(a) *In general*—(1) *Determination, etc.* A qualified investment entity is allowed a deduction for a deficiency dividend only if there is a determination (as defined in section 860(e) and paragraph (b)(1) of this section) that results in an adjustment (as defined in section 860(d) (1) or (2)) for the taxable year for which the deficiency dividend is paid. An adjustment does not include an increase in the excess of (i) the taxpayer's interest income excludable from gross income under section 103(a) over (ii) its deductions disallowed under sections 265 and 171(a)(2).

(2) *Payment date and claim.* The deficiency dividend must be paid on, or within 90 days after, the date of the determination and before the filing of a claim under section 860(g) and paragraph (b)(2) of this section. This claim must be filed within 120 days after the date of the determination.

(3) *Nature and amount of distribution.* (i) The deficiency dividend must be a distribution of property (including money) that would have been properly taken into account in computing the dividends paid deduction under section 561 for the taxable year for which tax liability resulting from the determination exists if the property had been distributed during that year. Thus, if the distribution would have been a dividend under section 316(a) if it had been made during the taxable year for which the determination applies, and the distribution may qualify under sections 316(b)(3), 562(a), and 860(f)(1), even though the distributing corporation, trust, or association has no current or accumulated earnings and profits for the taxable year in which the distribution is actually made. The amount of the distribution is determined under section 301 as of the date of the distribution.

The amount of the deduction is subject to the applicable limitations under sections 562 and 860(f)(2). Thus, if the entity distributes to an individual shareholder property (other than money) which on the date of the distribution has a fair market value in excess of its adjusted basis in the hands of the entity, the amount of the deficiency dividend in the individual's hands for purposes of section 316(b)(3) is determined by using the property's fair market value on that date. Nevertheless, the amount of the deficiency dividend the entity may deduct is limited, under § 1.562–1(a), to the adjusted basis of the property and the amount taxable to the individual as a dividend is determined by reference to the current and accumulated earnings and profits for the year to which the determination applies.

(ii) The qualified investment entity does not have to distribute the full amount of the adjustment in order to pay a deficiency dividend. For example, assume that in 1983 a determination with respect to a calendar year regulated investment company results in an increase of $100 in investment company taxable income (computed without the dividends paid deduction) for 1981 and no other change. The regulated investment company may choose to pay a deficiency dividend of $100 or of any lesser amount and be allowed a dividends paid deduction for 1981 for the amount of that deficiency dividend.

(4) *Status of distributor.* The corporation, trust, or association that pays the deficiency dividend does not have to be a qualified investment entity at the time of payment.

(5) *Certain definitions to apply.* For purposes of sections 860(d) (defining adjustment) and (f)(2) (limitations) the definitions of the terms ''investment company taxable income,'' ''real estate investment trust taxable income,'' and ''capital gains dividends'' in sections 852(b)(2), 857(b)(2), 852(b)(3)(C), and 857(b)(3)(C) apply, as appropriate to the particular entity.

(b) *Determination and claim for deduction*—(1) *Determination.* For purposes of applying section 860(e), the following rules apply:

(i) The date of determination by a decision of the United States Tax Court, the date upon which a judgment of a

court becomes final, and the date of determination by a closing agreement shall be determined under the rules in § 1.547–2(b)(1) (ii), (iii), and (iv).

(ii) A determination under section 860(e)(3) may be made by an agreement signed by the district director or another official to whom authority to sign the agreement is delegated, and by or on behalf of the taxpayer. The agreement shall set forth the amount, if any, of each adjustment described in subparagraphs (A), (B), and (C) of section 860(d) (1) or (2) (as appropriate) for the taxable year and the amount of the liability for any tax imposed by section 11(a), 56(a), 852(b)(1), 852(b)(3)(A), 857(b)(1), 857(b)(3)(A), or 1201(a) for the taxable year. The agreement shall also set forth the amount of the limitation (determined under section 860(f)(2)) on the amount of deficiency dividends that can qualify as capital gain dividends and ordinary dividends, respectively, for the taxable year. An agreement under this subdivision (ii) which is signed by the district director (or other delegate) shall be sent to the taxpayer at its last known address by either registered or certified mail. For further guidance regarding the definition of last known address, see § 301.6212–2 of this chapter. If registered mail is used, the date of registration is the date of determination. If certified mail is used, the date of the postmark on the sender's receipt is the date of determination. However, if a dividend is paid by the taxpayer before the registration or postmark date, but on or after the date the agreement is signed by the district director (or other delegate), the date of determination is the date of signing.

(2) *Claim for deduction*. A claim for deduction for a deficiency dividend shall be made, with the requisite declaration, on Form 976 and shall contain the following information and have the following attachments:

(i) The name, address, and taxpayer identification number of the corporation, trust, or association;

(ii) The amount of the deficiency and the taxable year or years involved;

(iii) The amount of the unpaid deficiency or, if the deficiency has been paid in whole or in part, the date of payment and the amount thereof;

(iv) A statement as to how the deficiency was established (*i.e.*, by an agreement under section 860(e)(3), by a closing agreement under section 7121, or by a decision of the Tax Court or court judgment);

(v) Any date or other information with respect to the determination that is required by Form 976;

(vi) The amount and date of payment of the dividend with respect to which the claim for the deduction for deficiency dividends is filed;

(vii) The amount claimed as a deduction for deficiency dividends;

(viii) If the amount claimed as a deduction for deficiency dividends includes any amount designated (or to be designated) as capital gain dividends, the amount of capital gain dividends for which a deficiency dividend deduction is claimed;

(ix) Any other information required by the claim form;

(x) A certified copy of the resolution of the trustees, directors, or other authority authorizing the payment of the dividend with respect to which the claim is filed; and

(xi) A copy of any court decision, judgment, agreement, or other document required by Form 976.

(3) *Filing claim*. The claim, together with the accompanying documents, shall be filed with the district director, or director of the internal revenue service center, with whom the income tax return for the taxable year for which the determination applies was filed. In the event that the determination is an agreement with the district director (or other delegate) described in section 860(e)(3) and paragraph (b)(1)(ii) of this section, the claim may be filed with the district director with whom (or pursuant to whose delegation) the agreement was made.

(The reporting requirements of this section were approved by the Office of Management and Budget under control number 1545–0045)

(Sec. 7805, 68A Stat. 917; 26 U.S.C. 7805; sec. 860(e) (92 Stat. 2849, 26 U.S.C. 860(e)); sec. 860(g) (92 Stat. 2850, 26 U.S.C. 860(g)))

[T.D. 7936, 49 FR 2107, Jan. 18, 1984; 49 FR 3177, Jan. 26, 1984, as amended by T.D. 8939, 66 FR 2819, Jan. 12, 2001]

§ 1.860–3 Interest and additions to tax.

(a) *In general.* If a qualified investment entity is allowed a deduction for deficiency dividends with respect to a taxable year, under section 860(c)(1) the tax imposed on the entity by chapter 1 of the Code (computed by taking into account the deduction) for that year is deemed to be increased by the amount of the deduction. This deemed increase in tax, however, applies solely for purposes of determining the liability of the entity for interest under subchapter A of chapter 67 of the Code and for additions to tax and additional amounts under chapter 68 of the Code. For purposes of applying subchapter A of chapter 67 and 68, the last date prescribed for payment of the deemed increase in tax is considered to be the last date prescribed for the payment of tax (determined in the manner provided in section 6601(b)) for the taxable year for which the deduction for deficiency dividends is allowed. The deemed increase in tax is considered to be paid as of the date that the claim for the deficiency dividend deduction described in section 860(g) is filed.

(b) *Overpayments of tax.* If a qualified investment entity is entitled to a credit or refund of an overpayment of the tax imposed by chapter 1 of the Code for the taxable year for which the deficiency dividend deduction is allowed, then, for purposes of computing interest, additions to tax, and additional amounts, the payment (or payments) that result in the overpayment and that precede the filing of the claim described in section 860(g) will be applied against and reduce the increase in tax that is deemed to occur under section 860(c)(1).

(c) *Examples.* This section is illustrated by the following examples:

Example 1. Corporation X is a real estate investment trust that files its income tax return on a calendar year basis. X receives an extension of time until June 15, 1978, to file its 1977 income tax return and files the return on May 15, 1978. X does not elect to pay any tax due in installments. For 1977, X reports real estate investment trust taxable income (computed without the dividends paid deduction) of $100, a dividends paid deduction of $100, and no tax liability. Following an examination of X's 1977 return, the district director and X enter into an agreement which is a determination under section 860(e)(3). The determination is dated November 1, 1979, and increases X's real estate investment trust taxable income (computed without the dividends paid deduction) by $20 to $120. Thus, taking into account the $100 of dividends paid in 1977, X has undistributed real estate investment trust taxable income of $20 as a result of the determination. X pays a dividend of $20 on November 10, 1979, files a claim for a deficiency dividend deduction of this $20 pursuant to section 860(g) on November 15, 1979, and is allowed a deficiency dividend deduction of $20 for 1977. After taking into account this deduction, X has no real estate investment trust taxable income and meets the distribution requirements of section 857(a)(1). However, for purposes of section 6601 (relating to interest on underpayment of tax), the tax imposed by chapter 1 of the Code on X for 1977 is deemed increased by this $20, and the last date prescribed for payment of the tax is March 15, 1978 (the due date of the 1977 return determined without any extension of time). The tax of $20 is deemed paid on November 15, 1979, the date the claim for the deficiency dividend deduction is filed. Thus, X is liable for interest on $20, at the rate established under section 6621, for the period from March 15, 1978, to November 15, 1979. Also, for purposes of determining whether X is liable for any addition to tax or additional amount imposed by chapter 68 of the Code (including the penalty prescribed by section 6697), the amount of tax imposed on X by chapter 1 of the Code is deemed to be increased by $20 (the amount of the deficiency dividend deduction allowed), the last date prescribed for payment of such tax is March 15, 1978, and the tax of $20 is deemed to be paid on November 15, 1979. X, however, is not subject to interest and penalties for the amount of any tax for which it would have been liable under section 11(a), 56(a), 1201(a), or 857(b) had it not been allowed the $20 deduction for deficiency dividends.

Example 2. Assume the facts are the same as in example (1) except that the district director, upon examining X's income tax return, asserts an income tax deficiency of $4, based on an asserted increase of $10 in real estate investment trust taxable income, and no agreement is entered into between the parties. X pays the $4 on June 1, 1979, and files suit for refund in the United States District Court. The District Court, in a decision which becomes final on November 1, 1980, holds that X did fail to report $10 of real estate investment trust taxable income and is not entitled to any refund. (No other item of income or deduction is in issue.) X pays a dividend of $10 on November 10, 1980, files a claim for a deficiency dividend deduction of this $10 on November 15, 1980, and is allowed a deficiency dividend deduction of $10 for 1977. Assume further that $4 is refunded to X on December 31, 1980, as the result of the $10

deficiency dividend deduction being allowed. Also assume that any assessable penalties, additional amounts, and additions to tax (including the penalty imposed by section 6697) for which X is liable are paid within 10 days of notice and demand, so that no interest is imposed on such penalties, etc. X's liability for interest for the period March 15, 1978, to June 1, 1979, is determined with respect to $10 (the amount of the deficiency dividend deduction allowed). X's liability for interest for the period June 1, 1979, to November 15, 1980, is determined with respect to $6, *i.e.*, $10 minus the $4 payment. X is entitled to interest on the $4 overpayment for the period described in section 6611(b)(2), beginning on November 15, 1980.

(Sec. 7805, 68A Stat. 917; 26 U.S.C. 7805; sec. 860(e) (92 Stat. 2849, 26 U.S.C. 860(e)); sec. 860(g) (92 Stat. 2850, 26 U.S.C. 860(g)))

[T.D. 7936, 49 FR 2108, Jan. 18, 1984]

§ 1.860–4 Claim for credit or refund.

If the allowance of a deduction for a deficiency dividend results in an overpayment of tax, the taxpayer, in order to secure credit or refund of the overpayment, must file a claim on Form 1120X in addition to the claim for the deficiency dividend deduction required under section 860(g). The credit or refund will be allowed as if on the date of the determination (as defined in section 860(e)) two years remained before the expiration of the period of limitations on the filing of claim for refund for the taxable year to which the overpayment relates.

(The reporting requirements of this section were approved by the Office of Management and Budget under control number 1545–0045)

(Sec. 7805, 68A Stat. 917; 26 U.S.C. 7805; sec. 860(e) (92 Stat. 2849, 26 U.S.C. 860(e)); sec. 860(g) (92 Stat. 2850, 26 U.S.C. 860(g)))

[T.D. 7936, 49 FR 2109, Jan. 18, 1984]

§ 1.860–5 Effective date.

(a) *In general.* Section 860 and §§ 1.860–1 through 1.860–4 apply with respect to determinations after November 6, 1978.

(b) *Prior determination of real estate investments trusts.* Section 859 (as in effect before the enactment of the Revenue Act of 1978) applies to determinations with respect to real estate investment trusts occurring after October 4, 1976, and before November 7, 1978. In the case of such a determination, the rules in §§ 1.860–1 through 1.860–4 apply, a reference in this chapter 1 to section 860 (or to a particular provision of section 860) shall be considered to be a reference to section 859 (or to the corresponding substantive provision of section 859), as in effect before enactment of the Revenue Act of 1978, and ''qualified investment entity'' in §§ 1.381(c)25–1(a) and 1.860–1 through 1.860–3 means a real estate investment trust.

(Sec. 7805, 68A Stat. 917; 26 U.S.C. 7805; sec. 860(e) (92 Stat. 2849, 26 U.S.C. 860(e)); sec. 860(g) (92 Stat. 2850, 26 U.S.C. 860(g)))

[T.D. 7936, 49 FR 2109, Jan. 18, 1984]

§ 1.860A–0 Outline of REMIC provisions.

This section lists the paragraphs contained in §§ 1.860A–1 through 1.860G–3.

Section 1.860A–1 Effective dates and transition rules.

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(b) Exceptions.
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(2) Tax avoidance rules.
(i) Transfers of certain residual interests.
(ii) Transfers to foreign holders.
(iii) Residual interests that lack significant value.
(3) Excise taxes.
(4) Rate based on current interest rate.
(i) In general.
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(5) Accounting for REMIC net income of foreign persons.

§ 1.860C–2 Determination of REMIC taxable income or net loss.

(a) Treatment of gain or loss.
(b) Deductions allowable to a REMIC.
(1) In general.
(2) Deduction allowable under section 163.
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(5) Expenses and interest relating to tax-exempt income.

§ 1.860D–1 Definition of a REMIC.

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(1) Interests in a REMIC.
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(ii) De minimis interests.
(2) Certain rights not treated as interests.
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(iii) Reimbursement rights under credit enhancement contracts.
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(3) Asset test.
(i) In general.

(ii) Safe harbor.
(4) Arrangements test.
(5) Reasonable arrangements.
(i) Arrangements to prevent disqualified organizations from holding residual interests.
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[T.D. 8458, 57 FR 61299, Dec. 24, 1992; 58 FR 15089, Mar. 19, 1993, as amended by T.D. 8614, 60 FR 42787, Aug. 17, 1995; T.D. 9004, 67 FR 47453, July 19, 2002; T.D. 9128, 69 FR 26041, May 11, 2004; T.D. 9272, 71 FR 43365, Aug. 1, 2006; T.D. 9415, 73 FR 40172, July 14, 2008; T.D. 9463, 74 FR 47438, Sept. 16, 2009]

§ 1.860A–1 Effective dates and transition rules.

(a) *In general.* Except as otherwise provided in paragraph (b) of this section, the regulations under sections 860A through 860G are effective only for a qualified entity (as defined in § 1.860D–1(c)(3)) whose startup day (as defined in section 860G(a)(9) and § 1.860G–2(k)) is on or after November 12, 1991.

(b) *Exceptions*—(1) *Reporting regulations.* (i) Sections 1.860D–1(c) (1) and (3), and § 1.860D–1(d) (1) through (3) are effective after December 31, 1986.

(ii) Sections 1.860F–4 (a) through (e) are effective after December 31, 1986 and are applicable after that date except as follows:

(A) Section 1.860F–4(c)(1) is effective for REMICs with a startup day on or after November 10, 1988.

(B) Sections 1.860F–4(e)(1)(ii) (A) and (B) are effective for calendar quarters and calendar years beginning after December 31, 1988.

(C) Section 1.860F–4(e)(1)(ii)(C) is effective for calendar quarters and calendar years beginning after December 31, 1986 and ending before January 1, 1988.

(D) Section 1.860F–4(e)(1)(ii)(D) is effective for calendar quarters and calendar years beginning after December 31, 1987 and ending before January 1, 1990.

(2) *Tax avoidance rules*—(i) *Transfers of certain residual interests.* Section 1.860E–1(c) (concerning transfers of noneconomic residual interests) and § 1.860G–3(a)(4) (concerning transfers by a foreign holder to a United States person) are effective for transfers of residual interests on or after September 27, 1991.

(ii) *Transfers to foreign holders.* Generally, § 1.860G–3(a) (concerning transfers of residual interests to foreign holders) is effective for transfers of residual interests after April 20, 1992. However, § 1.860G–3(a) does not apply to a transfer of a residual interest in a REMIC by the REMIC's sponsor (or by another transferor contemporaneously with formation of the REMIC) on or before June 30, 1992, if—

(A) The terms of the regular interests and the prices at which regular interests were offered had been fixed on or before April 20, 1992;

(B) On or before June 30, 1992, a substantial portion of the regular interests in the REMIC were transferred, with the terms and at the prices that were fixed on or before April 20, 1992, to investors who were unrelated to the REMIC's sponsor at the time of the transfer; and

(C) At the time of the transfer of the residual interest, the expected future

distributions on the residual interest were equal to at least 30 percent of the anticipated excess inclusions (as defined in §1.860E–2(a)(3)), and the transferor reasonably expected that the transferee would receive sufficient distributions from the REMIC at or after the time at which the excess inclusions accrue in an amount sufficient to satisfy the taxes on the excess inclusions.

(iii) *Residual interests that lack significant value.* The significant value requirement in §1.860E–1(a) (1) and (3) (concerning excess inclusions accruing to organizations to which section 593 applies) generally is effective for residual interests acquired on or after September 27, 1991. The significant value requirement in §1.860E–1(a) (1) and (3) does not apply, however, to residual interests acquired by an organization to which section 593 applies as a sponsor at formation of a REMIC in a transaction described in §1.860F–2(a)(1) if more than 50 percent of the interests in the REMIC (determined by reference to issue price) were sold to unrelated investors before November 12, 1991. The exception from the significant value requirement provided by the preceding sentence applies only so long as the sponsor owns the residual interests.

(3) *Excise taxes.* Section 1.860E–2(a)(1) is effective for transfers of residual interests to disqualified organizations after March 31, 1988. Section 1.860E–2(b)(1) is effective for excess inclusions accruing to pass-thru entities after March 31, 1988.

(4) *Rate based on current interest rate*—(i) *In general.* Section 1.860G–1(a)(3)(i) applies to obligations (other than transition obligations described in paragraph (b)(4)(iii) of this section) intended to qualify as regular interests that are issued on or after April 4, 1994.

(ii) *Rate based on index.* Section 1.860G–1(a)(3)(i) (as contained in 26 CFR part 1 revised as of April 1, 1994) applies to obligations intended to qualify as regular interests that—

(A) Are issued by a qualified entity (as defined in §1.860D–1(c)(3)) whose startup date (as defined in section 860G(a)(9) and §1.860G–2(k)) is on or after November 12, 1991; and

(B) Are either—

(*1*) Issued before April 4, 1994; or

(*2*) Transition obligations described in paragraph (b)(4)(iii) of this section.

(iii) *Transition obligations.* Obligations are described in this paragraph (b)(4)(iii) if—

(A) The terms of the obligations and the prices at which the obligations are offered are fixed before April 4, 1994; and

(B) On or before June 1, 1994, a substantial portion of the obligations are transferred, with the terms and at the prices that are fixed before April 4, 1994, to investors who are unrelated to the REMIC's sponsor at the time of the transfer.

(5) Accounting for REMIC net income of foreign persons. Section 1.860G–3(b) is applicable to REMIC net income (including excess inclusions) of a foreign person with respect to a REMIC residual interest if the first net income allocation under section 860C(a)(1) to the foreign person with respect to that interest occurs on or after August 1, 2006.

(6) *Exceptions for certain modified obligations.* Paragraphs (a)(8)(i), (b)(3)(v), (b)(3)(vi), and (b)(7) of §1.860G–2 apply to modifications made to the terms of an obligation on or after September 16, 2009.

[T.D. 8458, 57 FR 61300, Dec. 24, 1992; 58 FR 8098, Feb. 11, 1993; 58 FR 15089, Mar. 19, 1993; T.D. 8614, 60 FR 42787, Aug. 17, 1995; T.D. 9272, 71 FR 43365, Aug. 1, 2006; T.D. 9415, 73 FR 40172, July 14, 2008; T.D. 9463, 74 FR 47438, Sept. 16, 2009]

§ 1.860C–1 Taxation of holders of residual interests.

(a) *Pass-thru of income or loss.* Any holder of a residual interest in a REMIC must take into account the holder's daily portion of the taxable income or net loss of the REMIC for each day during the taxable year on which the holder owned the residual interest.

(b) *Adjustments to basis of residual interests*—(1) *Increase in basis.* A holder's basis in a residual interest is increased by—

(i) The daily portions of taxable income taken into account by that holder under section 860C(a) with respect to that interest; and

(ii) The amount of any contribution described in section 860G(d)(2) made by that holder.

(2) *Decrease in basis.* A holder's basis in a residual interest is reduced (but not below zero) by—

(i) First, the amount of any cash or the fair market value of any property distributed to that holder with respect to that interest; and

(ii) Second, the daily portions of net loss of the REMIC taken into account under section 860C(a) by that holder with respect to that interest.

(3) *Adjustments made before disposition.* If any person disposes of a residual interest, the adjustments to basis prescribed in paragraph (b) (1) and (2) of this section are deemed to occur immediately before the disposition.

(c) *Counting conventions.* For purposes of determining the daily portion of REMIC taxable income or net loss under section 860C(a)(2), any reasonable convention may be used. An example of a reasonable convention is ''30 days per month/90 days per quarter/360 days per year.''

(d) For rules on the proper accounting for income from inducement fees, *see* § 1.446–6.

[T.D. 8458, 57 FR 61301, Dec. 24, 1992, as amended by T.D. 9128, 69 FR 26041, May 11, 2004]

§ 1.860C–2 Determination of REMIC taxable income or net loss.

(a) *Treatment of gain or loss.* For purposes of determining the taxable income or net loss of a REMIC under section 860C(b), any gain or loss from the disposition of any asset, including a qualified mortgage (as defined in section 860G(a)(3)) or a permitted investment (as defined in section 860G(a)(5) and § 1.860G–2(g)), is treated as gain or loss from the sale or exchange of property that is not a capital asset.

(b) *Deductions allowable to a REMIC*—(1) *In general.* Except as otherwise provided in section 860C(b) and in paragraph (b) (2) through (5) of this section, the deductions allowable to a REMIC for purposes of determining its taxable income or net loss are those deductions that would be allowable to an individual, determined by taking into account the same limitations that apply to an individual.

(2) *Deduction allowable under section 163.* A REMIC is allowed a deduction, determined without regard to section 163(d), for any interest expense accrued during the taxable year.

(3) *Deduction allowable under section 166.* For purposes of determining a REMIC's bad debt deduction under section 166, debt owed to the REMIC is not treated as nonbusiness debt under section 166(d).

(4) *Deduction allowable under section 212.* A REMIC is not treated as carrying on a trade or business for purposes of section 162. Ordinary and necessary operating expenses paid or incurred by the REMIC during the taxable year are deductible under section 212, without regard to section 67. Any expenses that are incurred in connection with the formation of the REMIC and that relate to the organization of the REMIC and the issuance of regular and residual interests are not treated as expenses of the REMIC for which a deduction is allowable under section 212. See § 1.860F–2(b)(3)(ii) for treatment of those expenses.

(5) *Expenses and interest relating to tax-exempt income.* Pursuant to section 265(a), a REMIC is not allowed a deduction for expenses and interest allocable to tax-exempt income. The portion of a REMIC's interest expense that is allocable to tax-exempt interest is determined in the manner prescribed in section 265(b)(2), without regard to section 265(b)(3).

[T.D. 8458, 57 FR 61301, Dec. 24, 1992]

§ 1.860D–1 Definition of a REMIC.

(a) *In general.* A real estate mortgage investment conduit (or REMIC) is a qualified entity, as defined in paragraph (c)(3) of this section, that satisfies the requirements of section 860D(a). See paragraph (d)(1) of this section for the manner of electing REMIC status.

(b) *Specific requirements*—(1) *Interests in a REMIC*—(i) *In general.* A REMIC must have one class, and only one class, of residual interests. Except as provided in paragraph (b)(1)(ii) of this section, every interest in a REMIC must be either a regular interest (as defined in section 860G(a)(1) and § 1.860G–1(a)) or a residual interest (as defined in section 860G(a)(2) and § 1.860G–1(c)).

(ii) *De minimis interests.* If, to facilitate the creation of an entity that

elects REMIC status, an interest in the entity is created and, as of the startup day (as defined in section 860G(a)(9) and §1.860G–2(k)), the fair market value of that interest is less than the lesser of $1,000 or 1/1,000 of one percent of the aggregate fair market value of all the regular and residual interests in the REMIC, then, unless that interest is specifically designated as an interest in the REMIC, the interest is not treated as an interest in the REMIC for purposes of section 860D(a) (2) and (3) and paragraph (B)(1)(i) of this section.

(2) *Certain rights not treated as interests.* Certain rights are not treated as interests in a REMIC. Although not an exclusive list, the following rights are not interests in a REMIC.

(i) *Payments for services.* The right to receive from the REMIC payments that represent reasonable compensation for services provided to the REMIC in the ordinary course of its operation is not an interest in the REMIC. Payments made by the REMIC in exchange for services may be expressed as a specified percentage of interest payments due on qualified mortgages or as a specified percentage of earnings from permitted investments. For example, a mortgage servicer's right to receive reasonable compensation for servicing the mortgages owned by the REMIC is not an interest in the REMIC.

(ii) *Stripped interests.* Stripped bonds or stripped coupons not held by the REMIC are not interests in the REMIC even if, in a transaction preceding or contemporaneous with the formation of the REMIC, they and the REMIC's qualified mortgages were created from the same mortgage obligation. For example, the right of a mortgage servicer to receive a servicing fee in excess of reasonable compensation from payments it receives on mortgages held by a REMIC is not an interest in the REMIC. Further, if an obligation with a fixed principal amount provides for interest at a fixed or variable rate and for certain contingent payment rights (*e.g.*, a shared appreciation provision or a percentage of mortgagor profits provision), and the owner of the obligation contributes the fixed payment rights to a REMIC and retains the contingent payment rights, the retained contingent payment rights are not an interest in the REMIC.

(iii) *Reimbursement rights under credit enhancement contracts.* A credit enhancer's right to be reimbursed for amounts advanced to a REMIC pursuant to the terms of a credit enhancement contract (as defined in §1.860G–2(c)(2)) is not an interest in the REMIC even if the credit enhancer is entitled to receive interest on the amounts advanced.

(iv) *Rights to acquire mortgages.* The right to acquire or the obligation to purchase mortgages and other assets from a REMIC pursuant to a clean-up call (as defined in §1.860G–2(j)) or a qualified liquidation (as defined in section 860F(a)(4)), or on conversion of a convertible mortgage (as defined in §1.860G–2(d)(5)), is not an interest in the REMIC.

(3) *Asset test*—(i) *In general.* For purposes of the asset test of section 860D(a)(4), substantially all of a qualified entity's assets are qualified mortgages and permitted investments if the qualified entity owns no more than a de minimis amount of other assets.

(ii) *Safe harbor.* The amount of assets other than qualified mortgages and permitted investments is de minimis if the aggregate of the adjusted bases of those assets is less than one percent of the aggregate of the adjusted bases of all of the REMIC's assets. Nonetheless, a qualified entity that does not meet this safe harbor may demonstrate that it owns no more than a de minimis amount of other assets.

(4) *Arrangements test.* Generally, a qualified entity must adopt reasonable arrangements designed to ensure that—

(i) Disqualified organizations (as defined in section 860E(e)(5)) do not hold residual interests in the qualified entity; and

(ii) If a residual interest is acquired by a disqualified organization, the qualified entity will provide to the Internal Revenue Service, and to the persons specified in section 860E(e)(3), information needed to compute the tax imposed under section 860E(e) on transfers of residual interests to disqualified organizations.

(5) *Reasonable arrangements*—(i) *Arrangements to prevent disqualified organizations from holding residual interests.* A qualified entity is considered to have adopted reasonable arrangements to ensure that a disqualified organization (as defined in section 860E(e)(5)) will not hold a residual interest if—

(A) The residual interest is in registered form (as defined in §5f.103–1(c) of this chapter); and

(B) The qualified entity's organizational documents clearly and expressly prohibit a disqualified organization from acquiring beneficial ownership of a residual interest, and notice of the prohibition is provided through a legend on the document that evidences ownership of the residual interest or through a conspicuous statement in a prospectus or private offering document used to offer the residual interest for sale.

(ii) *Arrangements to ensure that information will be provided.* A qualified entity is considered to have made reasonable arrangements to ensure that the Internal Revenue Service and persons specified in section 860E(e)(3) as liable for the tax imposed under section 860E(e) receive the information needed to compute the tax if the qualified entity's organizational documents require that it provide to the Internal Revenue Service and those persons a computation showing the present value of the total anticipated excess inclusions with respect to the residual interest for periods after the transfer. See §1.860E–2(a)(5) for the obligation to furnish information on request.

(6) *Calendar year requirement.* A REMIC's taxable year is the calendar year. The first taxable year of a REMIC begins on the startup day and ends on December 31 of the same year. If the startup day is other than January 1, the REMIC has a short first taxable year.

(c) *Segregated pool of assets*—(1) *Formation of REMIC.* A REMIC may be formed as a segregated pool of assets rather than as a separate entity. To constitute a REMIC, the assets identified as part of the segregated pool must be treated for all Federal income tax purposes as assets of the REMIC and interests in the REMIC must be based solely on assets of the REMIC.

(2) *Identification of assets.* Formation of the REMIC does not occur until—

(i) The sponsor identifies the assets of the REMIC, such as through execution of an indenture with respect to the assets; and

(ii) The REMIC issues the regular and residual interests in the REMIC.

(3) *Qualified entity defined.* For purposes of this section, the term ''qualified entity'' includes an entity or a segregated pool of assets within an entity.

(d) *Election to be treated as a real estate mortgage investment conduit*—(1) *In general.* A qualified entity, as defined in paragraph (c)(3) of this section, elects to be treated as a REMIC by timely filing, for the first taxable year of its existence, a Form 1066, U.S. Real Estate Mortgage Investment Conduit Income Tax Return, signed by a person authorized to sign that return under §1.860F–4(c). See §1.9100–1 for rules regarding extensions of time for making elections. Once made, this election is irrevocable for that taxable year and all succeeding taxable years.

(2) *Information required to be reported in the REMIC's first taxable year.* For the first taxable year of the REMIC's existence, the qualified entity, as defined in paragraph (c)(3) of this section, must provide either on its return or in a separate statement attached to its return—

(i) The REMIC's employer identification number, which must not be the same as the identification number of any other entity,

(ii) Information concerning the terms and conditions of the regular interests and the residual interest of the REMIC, or a copy of the offering circular or prospectus containing such information,

(iii) A description of the prepayment and reinvestment assumptions that are made pursuant to section 1272(a)(6) and the regulations thereunder, including a statement supporting the selection of the prepayment assumption,

(iv) The form of the electing qualified entity under State law or, if an election is being made with respect to a segregated pool of assets within an entity, the form of the entity that holds the segregated pool of assets, and

(v) Any other information required by the form.

(3) *Requirement to keep sufficient records.* A qualified entity, as defined in paragraph (c)(3) of this section, that elects to be a REMIC must keep sufficient records concerning its investments to show that it has complied with the provisions of sections 860A through 860G and the regulations thereunder during each taxable year.

[T.D. 8366, 56 FR 49516, Sept. 30, 1991; T.D. 8458, 57 FR 61301, Dec. 24, 1992]

§ 1.860E–1 Treatment of taxable income of a residual interest holder in excess of daily accruals.

(a) *Excess inclusion cannot be offset by otherwise allowable deductions*—(1) *In general.* Except as provided in paragraph (a)(3) of this section, the taxable income of any holder of a residual interest for any taxable year is in no event less than the sum of the excess inclusions attributable to that holder's residual interests for that taxable year. In computing the amount of a net operating loss (as defined in section 172(c)) or the amount of any net operating loss carryover (as defined in section 172(b)(2)), the amount of any excess inclusion is not included in gross income or taxable income. Thus, for example, if a residual interest holder has $100 of gross income, $25 of which is an excess inclusion, and $90 of business deductions, the holder has taxable income of $25, the amount of the excess inclusion, and a net operating loss of $15 ($75 of other income − $90 of business deductions).

(2) *Affiliated groups.* If a holder of a REMIC residual interest is a member of an affiliated group filing a consolidated income tax return, the taxable income of the affiliated group cannot be less than the sum of the excess inclusions attributable to all residual interests held by members of the affiliated group.

(3) *Special rule for certain financial institutions*—(i) *In general.* If an organization to which section 593 applies holds a residual interest that has significant value (as defined in paragraph (a)(3)(iii) of this section), section 860E(a)(1) and paragraph (a)(1) of this section do not apply to that organization with respect to that interest. Consequently, an organization to which section 593 applies may use its allowable deductions to offset an excess inclusion attributable to a residual interest that has significant value, but, except as provided in section 860E(a)(4)(A), may not use its allowable deductions to offset an excess inclusion attributable to a residual interest held by any other member of an affiliated group, if any, of which the organization is a member. Further, a net operating loss of any other member of an affiliated group of which the organization is a member may not be used to offset an excess inclusion attributable to a residual interest held by that organization.

(ii) *Ordering rule*—(A) *In general.* In computing taxable income for any year, an organization to which section 593 applies is treated as having applied its allowable deductions for the year first to offset that portion of its gross income that is not an excess inclusion and then to offset that portion of its income that is an excess inclusion.

(B) *Example.* The following example illustrates the provisions of paragraph (a)(3)(ii) of this section:

Example. Corp. *X*, a corporation to which section 593 applies, is a member of an affiliated group that files a consolidated return. For a particular taxable year, Corp. *X* has gross income of $1,000, and of this amount, $150 is an excess inclusion attributable to a residual interest that has significant value. Corp. *X* has $975 of allowable deductions for the taxable year. Corp. *X* must apply its allowable deductions first to offset the $850 of gross income that is not an excess inclusion, and then to offset the portion of its gross income that is an excess inclusion. Thus, Corp. *X* has $25 of taxable income ($1,000 − $975), and that $25 is an excess inclusion that may not be offset by losses sustained by other members of the affiliated group.

(iii) *Significant value.* A residual interest has significant value if—

(A) The aggregate of the issue prices of the residual interests in the REMIC is at least 2 percent of the aggregate of the issue prices of all residual and regular interests in the REMIC; and

(B) The anticipated weighted average life of the residual interests is at least 20 percent of the anticipated weighted average life of the REMIC.

(iv) *Determining anticipated weighted average life*—(A) *Anticipated weighted average life of the REMIC.* The anticipated weighted average life of a REMIC

is the weighted average of the anticipated weighted average lives of all classes of interests in the REMIC. This weighted average is determined under the formula in paragraph (a)(3)(iv)(B) of this section, applied by treating all payments taken into account in computing the anticipated weighted average lives of regular and residual interests in the REMIC as principal payments on a single regular interest.

(B) *Regular interests that have a specified principal amount.* Generally, the anticipated weighted average life of a regular interest is determined by—

(*1*) Multiplying the amount of each anticipated principal payment to be made on the interest by the number of years (including fractions thereof) from the startup day (as defined in section 860G(a)(9) and § 1.860G–2(k)) to the related principal payment date;

(*2*) Adding the results; and

(*3*) Dividing the sum by the total principal paid on the regular interest.

(C) *Regular interests that have no specified principal amount or that have only a nominal principal amount, and all residual interests.* If a regular interest has no specified principal amount, or if the interest payments to be made on a regular interest are disproportionately high relative to its specified principal amount (as determined by reference to § 1.860G–1(b)(5)(i)), then, for purposes of computing the anticipated weighted average life of the interest, all anticipated payments on that interest, regardless of their designation as principal or interest, must be taken into account in applying the formula set out in paragraph (a)(3)(iv)(B) of this section. Moreover, for purposes of computing the weighted average life of a residual interest, all anticipated payments on that interest, regardless of their designation as principal or interest, must be taken into account in applying the formula set out in paragraph (a)(3)(iv)(B) of this section.

(D) *Anticipated payments.* The anticipated principal payments to be made on a regular interest subject to paragraph (a)(3)(iv)(B) of this section, and the anticipated payments to be made on a regular interest subject to paragraph (a)(3)(iv)(C) of this section or on a residual interest, must be determined based on—

(*1*) The prepayment and reinvestment assumptions adopted under section 1272(a)(6), or that would have been adopted had the REMIC's regular interests been issued with original issue discount; and

(*2*) Any required or permitted clean up calls or any required qualified liquidation provided for in the REMIC's organizational documents.

(b) *Treatment of residual interests held by REITs, RICs, common trust funds, and subchapter T cooperatives.* [Reserved]

(c) *Transfers of noneconomic residual interests*—(1) *In general.* A transfer of a noneconomic residual interest is disregarded for all Federal tax purposes if a significant purpose of the transfer was to enable the transferor to impede the assessment or collection of tax. A significant purpose to impede the assessment or collection of tax exists if the transferor, at the time of the transfer, either knew or should have known (had ''improper knowledge'') that the transferee would be unwilling or unable to pay taxes due on its share of the taxable income of the REMIC.

(2) *Noneconomic residual interest.* A residual interest is a noneconomic residual interest unless, at the time of the transfer—

(i) The present value of the expected future distributions on the residual interest at least equals the product of the present value of the anticipated excess inclusions and the highest rate of tax specified in section 11(b)(1) for the year in which the transfer occurs; and

(ii) The transferor reasonably expects that, for each anticipated excess inclusion, the transferee will receive distributions from the REMIC at or after the time at which the taxes accrue on the anticipated excess inclusion in an amount sufficient to satisfy the accrued taxes.

(3) *Computations.* The present value of the expected future distributions and the present value of the anticipated excess inclusions must be computed under the procedure specified in § 1.860E–2(a)(4) for determining the present value of anticipated excess inclusions in connection with the transfer of a residual interest to a disqualified organization.

(4) *Safe harbor for establishing lack of improper knowledge.* A transferor is presumed not to have improper knowledge if—

(i) The transferor conducted, at the time of the transfer, a reasonable investigation of the financial condition of the transferee and, as a result of the investigation, the transferor found that the transferee had historically paid its debts as they came due and found no significant evidence to indicate that the transferee will not continue to pay its debts as they come due in the future;

(ii) The transferee represents to the transferor that it understands that, as the holder of the noneconomic residual interest, the transferee may incur tax liabilities in excess of any cash flows generated by the interest and that the transferee intends to pay taxes associated with holding the residual interest as they become due;

(iii) The transferee represents that it will not cause income from the noneconomic residual interest to be attributable to a foreign permanent establishment or fixed base (within the meaning of an applicable income tax treaty) of the transferee or another U.S. taxpayer; and

(iv) The transfer satisfies either the asset test in paragraph (c)(5) of this section or the formula test in paragraph (c)(7) of this section.

(5) *Asset test.* The transfer satisfies the asset test if it meets the requirements of paragraphs (c)(5)(i), (ii) and (iii) of this section.

(i) At the time of the transfer, and at the close of each of the transferee's two fiscal years preceding the transferee's fiscal year of transfer, the transferee's gross assets for financial reporting purposes exceed $100 million and its net assets for financial reporting purposes exceed $10 million. For purposes of the preceding sentence, the gross assets and net assets of a transferee do not include any obligation of any related person (as defined in paragraph (c)(6)(ii) of this section) or any other asset if a principal purpose for holding or acquiring the other asset is to permit the transferee to satisfy the conditions of this paragraph (c)(5)(i).

(ii) The transferee must be an eligible corporation (defined in paragraph (c)(6)(i) of this section) and must agree in writing that any subsequent transfer of the interest will be to another eligible corporation in a transaction that satisfies paragraphs (c)(4)(i), (ii), and (iii) and this paragraph (c)(5). The direct or indirect transfer of the residual interest to a foreign permanent establishment (within the meaning of an applicable income tax treaty) of a domestic corporation is a transfer that is not a transfer to an eligible corporation. A transfer also fails to meet the requirements of this paragraph (c)(5)(ii) if the transferor knows, or has reason to know, that the transferee will not honor the restrictions on subsequent transfers of the residual interest.

(iii) A reasonable person would not conclude, based on the facts and circumstances known to the transferor on or before the date of the transfer, that the taxes associated with the residual interest will not be paid. The consideration given to the transferee to acquire the noneconomic residual interest in the REMIC is only one factor to be considered, but the transferor will be deemed to know that the transferee cannot or will not pay if the amount of consideration is so low compared to the liabilities assumed that a reasonable person would conclude that the taxes associated with holding the residual interest will not be paid. In determining whether the amount of consideration is too low, the specific terms of the formula test in paragraph (c)(7) of this section need not be used.

(6) *Definitions for asset test.* The following definitions apply for purposes of paragraph (c)(5) of this section:

(i) *Eligible corporation* means any domestic C corporation (as defined in section 1361(a)(2)) other than—

(A) A corporation which is exempt from, or is not subject to, tax under section 11;

(B) An entity described in section 851(a) or 856(a);

(C) A REMIC; or

(D) An organization to which part I of subchapter T of chapter 1 of subtitle A of the Internal Revenue Code applies.

(ii) *Related person* is any person that—

(A) Bears a relationship to the transferee enumerated in section 267(b) or 707(b)(1), using ''20 percent'' instead of

''50 percent'' where it appears under the provisions; or

(B) Is under common control (within the meaning of section 52(a) and (b)) with the transferee.

(7) *Formula test*. The transfer satisfies the formula test if the present value of the anticipated tax liabilities associated with holding the residual interest does not exceed the sum of—

(i) The present value of any consideration given to the transferee to acquire the interest;

(ii) The present value of the expected future distributions on the interest; and

(iii) The present value of the anticipated tax savings associated with holding the interest as the REMIC generates losses.

(8) *Conditions and limitations on formula test*. The following rules apply for purposes of the formula test in paragraph (c)(7) of this section.

(i) The transferee is assumed to pay tax at a rate equal to the highest rate of tax specified in section 11(b)(1). If the transferee has been subject to the alternative minimum tax under section 55 in the preceding two years and will compute its taxable income in the current taxable year using the alternative minimum tax rate, then the tax rate specified in section 55(b)(1)(B) may be used in lieu of the highest rate specified in section 11(b)(1).

(ii) The direct or indirect transfer of the residual interest to a foreign permanent establishment or fixed base (within the meaning of an applicable income tax treaty) of a domestic transferee is not eligible for the formula test.

(iii) Present values are computed using a discount rate equal to the Federal short-term rate prescribed by section 1274(d) for the month of the transfer and the compounding period used by the taxpayer.

(9) *Examples*. The following examples illustrate the rules of this section:

Example 1. Transfer to partnership. *X* transfers a noneconomic residual interest in a REMIC to Partnership *P* in a transaction that does not satisfy the formula test of paragraph (c)(7) of this section. *Y* and *Z* are the partners of *P*. Even if *Y* and *Z* are eligible corporations that satisfy the requirements of paragraph (c)(5)(i) of this section, the transfer fails to satisfy the asset test requirements found in paragraph (c)(5)(ii) of this section because *P* is a partnership rather than an eligible corporation within the meaning of (c)(6)(i) of this section.

Example 2. Transfer to a corporation without capacity to carry additional residual interests. During the first ten months of a year, Bank transfers five residual interests to Corporation *U* under circumstances meeting the requirements of the asset test in paragraph (c)(5) of this section. Bank is the major creditor of *U* and consequently has access to *U*'s financial records and has knowledge of *U*'s financial circumstances. During the last month of the year, Bank transfers three additional residual interests to *U* in a transaction that does not meet the formula test of paragraph (c)(7) of this section. At the time of this transfer, *U*'s financial records indicate it has retained the previously transferred residual interests. *U*'s financial circumstances, including the aggregate tax liabilities it has assumed with respect to REMIC residual interests, would cause a reasonable person to conclude that *U* will be unable to meet its tax liabilities when due. The transfers in the last month of the year fail to satisfy the investigation requirement in paragraph (c)(4)(i) of this section and the asset test requirement of paragraph (c)(5)(iii) of this section because Bank has reason to know that *U* will not be able to pay the tax due on those interests.

Example 3. Transfer to a foreign permanent establishment of an eligible corporation. *R* transfers a noneconomic residual interest in a REMIC to the foreign permanent establishment of Corporation *T*. Solely because of paragraph (c)(8)(ii) of this section, the transfer does not satisfy the formula test of paragraph (c)(7) of this section. In addition, even if *T* is an eligible corporation, the transfer does not satisfy the asset test because the transfer fails the requirements of paragraph (c)(5)(ii) of this section.

(10) *Effective dates*. Paragraphs (c)(4) through (c)(9) of this section are applicable to transfers occurring on or after February 4, 2000, except for paragraphs (c)(4)(iii) and (c)(8)(iii) of this section, which are applicable for transfers occurring on or after August 19, 2002. For the dates of applicability of paragraphs (a) through (c)(3) and (d) of this section, see § 1.860A–1.

(d) *Transfers to foreign persons*. Paragraph (c) of this section does not apply to transfers of residual interests to which § 1.860G–3(a)(1), concerning transfers to certain foreign persons, applies.

[T.D. 8458, 57 FR 61302, Dec. 24, 1992; 58 FR 8098, Feb. 11, 1993; T.D. 9004, 67 FR 47453, July 19, 2002]

§ 1.860E–2 Tax on transfers of residual interests to certain organizations.

(a) *Transfers to disqualified organizations*—(1) *Payment of tax*. Any excise tax due under section 860E(e)(1) must be paid by the later of March 24, 1993, or April 15th of the year following the calendar year in which the residual interest is transferred to a disqualified organization. The Commissioner may prescribe rules for the manner and method of collecting the tax.

(2) *Transitory ownership*. For purposes of section 860E (e) and this section, a transfer of a residual interest to a disqualified organization in connection with the formation of a REMIC is disregarded if the disqualified organization has a binding contract to sell the interest and the sale occurs within 7 days of the startup day (as defined in section 860G(a)(9) and § 1.860G–2(k)).

(3) *Anticipated excess inclusions*. The anticipated excess inclusions are the excess inclusions that are expected to accrue in each calendar quarter (or portion thereof) following the transfer of the residual interest. The anticipated excess inclusions must be determined as of the date the residual interest is transferred and must be based on—

(i) Events that have occurred up to the time of the transfer;

(ii) The prepayment and reinvestment assumptions adopted under section 1272(a)(6), or that would have been adopted had the REMIC's regular interests been issued with original issue discount; and

(iii) Any required or permitted clean up calls, or required qualified liquidation provided for in the REMIC's organizational documents.

(4) *Present value computation*. The present value of the anticipated excess inclusions is determined by discounting the anticipated excess inclusions from the end of each remaining calendar quarter in which those excess inclusions are expected to accrue to the date the disqualified organization acquires the residual interest. The discount rate to be used for this present value computation is the applicable Federal rate (as specified in section 1274(d)(1)) that would apply to a debt instrument that was issued on the date the disqualified organization acquired the residual interest and whose term ended on the close of the last quarter in which excess inclusions were expected to accrue with respect to the residual interest.

(5) *Obligation of REMIC to furnish information*. A REMIC is not obligated to determine if its residual interests have been transferred to a disqualified organization. However, upon request of a person designated in section 860E(e)(3), the REMIC must furnish information sufficient to compute the present value of the anticipated excess inclusions. The information must be furnished to the requesting party and to the Internal Revenue Service within 60 days of the request. A reasonable fee charged to the requestor is not income derived from a prohibited transaction within the meaning of section 860F(a).

(6) *Agent*. For purposes of section 860E(e)(3), the term ''agent'' includes a broker (as defined in section 6045(c) and § 1.6045–1(a)(1)), nominee, or other middleman.

(7) *Relief from liability*—(i) *Transferee furnishes information under penalties of perjury*. For purposes of section 860E(e)(4), a transferee is treated as having furnished an affidavit if the transferee furnishes—

(A) A social security number, and states under penalties of perjury that the social security number is that of the transferee; or

(B) A statement under penalties of perjury that it is not a disqualified organization.

(ii) *Amount required to be paid*. The amount required to be paid under section 860E(e)(7)(B) is equal to the product of the highest rate specified in section 11(b)(1) for the taxable year in which the transfer described in section 860E(e)(1) occurs and the amount of excess inclusions that accrued and were allocable to the residual interest during the period that the disqualified organization held the interest.

(b) *Tax on pass-thru entities*—(1) *Tax on excess inclusions*. Any tax due under section 860E(e)(6) must be paid by the later of March 24, 1993, or by the fifteenth day of the fourth month following the close of the taxable year of the pass-thru entity in which the disqualified person is a record holder. The Commissioner may prescribe rules for

the manner and method of collecting the tax.

(2) *Record holder furnishes information under penalties of perjury*. For purposes of section 860E(e)(6)(D), a record holder is treated as having furnished an affidavit if the record holder furnishes—

(i) A social security number and states, under penalties of perjury, that the social security number is that of the record holder; or

(ii) A statement under penalties of perjury that it is not a disqualified organization.

(3) *Deductibility of tax*. Any tax imposed on a pass-thru entity pursuant to section 860E(e)(6)(A) is deductible against the gross amount of ordinary income of the pass-thru entity. For example, in the case of a REIT, the tax is deductible in determining real estate investment trust taxable income under section 857(b)(2).

(4) *Allocation of tax*. Dividends paid by a RIC or by a REIT are not preferential dividends within the meaning of section 562(c) solely because the tax expense incurred by the RIC or REIT under section 860E(e)(6) is allocated solely to the shares held by disqualified organizations.

[T.D. 8458, 57 FR 61304, Dec. 24, 1992]

§ 1.860F–1 Qualified liquidations.

A plan of liquidation need not be in any special form. If a REMIC specifies the first day in the 90-day liquidation period in a statement attached to its final return, then the REMIC will be considered to have adopted a plan of liquidation on the specified date.

[T.D. 8458, 57 FR 61304, Dec. 24, 1992]

§ 1.860F–2 Transfers to a REMIC.

(a) *Formation of a REMIC*—(1) *In general*. For Federal income tax purposes, a REMIC formation is characterized as the contribution of assets by a sponsor (as defined in paragraph (b)(1) of this section) to a REMIC in exchange for REMIC regular and residual interests. If, instead of exchanging its interest in mortgages and related assets for regular and residual interests, the sponsor arranges to have the REMIC issue some or all of the regular and residual interests for cash, after which the sponsor sells its interests in mortgages and related assets to the REMIC, the transaction is, nevertheless, viewed for Federal income tax purposes as the sponsor's exchange of mortgages and related assets for regular and residual interests, followed by a sale of some or all of those interests. The purpose of this rule is to ensure that the tax consequences associated with the formation of a REMIC are not affected by the actual sequence of steps taken by the sponsor.

(2) *Tiered arrangements*—(i) *Two or more REMICs formed pursuant to a single set of organizational documents*. Two or more REMICs can be created pursuant to a single set of organizational documents even if for state law purposes or for Federal securities law purposes those documents create only one organization. The organizational documents must, however, clearly and expressly identify the assets of, and the interests in, each REMIC, and each REMIC must satisfy all of the requirements of section 860D and the related regulations.

(ii) *A REMIC and one or more investment trusts formed pursuant to a single set of documents*. A REMIC (or two or more REMICs) and one or more investment trusts can be created pursuant to a single set of organizational documents and the separate existence of the REMIC(s) and the investment trust(s) will be respected for Federal income tax purposes even if for state law purposes or for Federal securities law purposes those documents create only one organization. The organizational documents for the REMIC(s) and the investment trust(s) must, however, require both the REMIC(s) and the investment trust(s) to account for items of income and ownership of assets for Federal tax purposes in a manner that respects the separate existence of the multiple entities. See § 1.860G–2(i) concerning issuance of regular interests coupled with other contractual rights for an illustration of the provisions of this paragraph.

(b) *Treatment of sponsor*—(1) *Sponsor defined*. A sponsor is a person who directly or indirectly exchanges qualified mortgages and related assets for regular and residual interests in a REMIC. A person indirectly exchanges interests

in qualified mortgages and related assets for regular and residual interests in a REMIC if the person transfers, other than in a nonrecognition transaction, the mortgages and related assets to another person who acquires a transitory ownership interest in those assets before exchanging them for interests in the REMIC, after which the transitory owner then transfers some or all of the interests in the REMIC to the first person.

(2) *Nonrecognition of gain or loss.* The sponsor does not recognize gain or loss on the direct or indirect transfer of any property to a REMIC in exchange for regular or residual interests in the REMIC. However, the sponsor, upon a subsequent sale of the REMIC regular or residual interests, may recognize gain or loss with respect to those interests.

(3) *Basis of contributed assets allocated among interests*—(i) *In general.* The aggregate of the adjusted bases of the regular and residual interests received by the sponsor in the exchange described in paragraph (a) of this section is equal to the aggregate of the adjusted bases of the property transferred by the sponsor in the exchange, increased by the amount of organizational expenses (as described in paragraph (b)(3)(ii) of this section). That total is allocated among all the interests received in proportion to their fair market values on the pricing date (as defined in paragraph (b)(3)(iii) of this section) if any, or, if none, the startup day (as defined in section 860G(a)(9) and § 1.860G–2(k)).

(ii) *Organizational expenses*—(A) *Organizational expense defined.* An organizational expense is an expense that is incurred by the sponsor or by the REMIC and that is directly related to the creation of the REMIC. Further, the organizational expense must be incurred during a period beginning a reasonable time before the startup day and ending before the date prescribed by law for filing the first REMIC tax return (determined without regard to any extensions of time to file). The following are examples of organizational expenses: legal fees for services related to the formation of the REMIC, such as preparation of a pooling and servicing agreement and trust indenture; accounting fees related to the formation of the REMIC; and other administrative costs related to the formation of the REMIC.

(B) *Syndication expenses.* Syndication expenses are not organizational expenses. Syndication expenses are those expenses incurred by the sponsor or other person to market the interests in a REMIC, and, thus, are applied to reduce the amount realized on the sale of the interests. Examples of syndication expenses are brokerage fees, registration fees, fees of an underwriter or placement agent, and printing costs of the prospectus or placement memorandum and other selling or promotional material.

(iii) *Pricing date.* The term ''pricing date'' means the date on which the terms of the regular and residual interests are fixed and the prices at which a substantial portion of the regular interests will be sold are fixed.

(4) *Treatment of unrecognized gain or loss*—(i) *Unrecognized gain on regular interests.* For purposes of section 860F(b)(1)(C)(i), the sponsor must include in gross income the excess of the issue price of a regular interest over the sponsor's basis in the interest as if the excess were market discount (as defined in section 1278(a)(2)) on a bond and the sponsor had made an election under section 1278(b) to include this market discount currently in gross income. The sponsor is not, however, by reason of this paragraph (b)(4)(i), deemed to have made an election under section 1278(b) with respect to any other bonds.

(ii) *Unrecognized loss on regular interests.* For purposes of section 860F(b)(1)(D)(i), the sponsor treats the excess of the sponsor's basis in a regular interest over the issue price of the interest as if that excess were amortizable bond premium (as defined in section 171(b)) on a taxable bond and the sponsor had made an election under section 171(c). The sponsor is not, however, by reason of this paragraph (b)(4)(ii), deemed to have made an election under section 171(c) with respect to any other bonds.

(iii) *Unrecognized gain on residual interests.* For purposes of section 860F(b)(1)(C)(ii), the sponsor must include in gross income the excess of the issue price of a residual interest over

the sponsor's basis in the interest ratably over the anticipated weighted average life of the REMIC (as defined in § 1.860E–1(a)(3)(iv)).

(iv) *Unrecognized loss on residual interests.* For purposes of section 860F(b)(1)(D)(ii), the sponsor deducts the excess of the sponsor's basis in a residual interest over the issue price of the interest ratably over the anticipated weighted average life of the REMIC.

(5) *Additions to or reductions of the sponsor's basis.* The sponsor's basis in a regular or residual interest is increased by any amount included in the sponsor's gross income under paragraph (b)(4) of this section. The sponsor's basis in a regular or residual interest is decreased by any amount allowed as a deduction and by any amount applied to reduce interest payments to the sponsor under paragraph (b)(4)(ii) of this section.

(6) *Transferred basis property.* For purposes of paragraph (b)(4) of this section, a transferee of a regular or residual interest is treated in the same manner as the sponsor to the extent that the basis of the transferee in the interest is determined in whole or in part by reference to the basis of the interest in the hands of the sponsor.

(c) *REMIC's basis in contributed assets.* For purposes of section 860F(b)(2), the aggregate of the REMIC's bases in the assets contributed by the sponsor to the REMIC in a transaction described in paragraph (a) of this section is equal to the aggregate of the issue prices (determined under section 860G(a)(10) and § 1.86G–1(d)) of all regular and residual interests in the REMIC.

[T.D. 8458, 57 FR 61304, Dec. 24, 1992; 58 FR 8098, Feb. 11, 1993]

§ 1.860F–4 REMIC reporting requirements and other administrative rules.

(a) *In general.* Except as provided in paragraph (c) of this section, for purposes of subtitle F of the Internal Revenue Code, a REMIC is treated as a partnership and any holder of a residual interest in the REMIC is treated as a partner. A REMIC is not subject, however, to the rules of subchapter C of chapter 63 of the Internal Revenue Code, relating to the treatment of partnership items, for a taxable year if there is at no time during the taxable year more than one holder of a residual interest in the REMIC. The identity of a holder of a residual interest in a REMIC is not treated as a partnership item with respect to the REMIC for purposes of subchapter C of chapter 63.

(b) *REMIC tax return*—(1) *In general.* To satisfy the requirement under section 6031 to make a return of income for each taxable year, a REMIC must file the return required by paragraph (b)(2) of this section. The due date and any extensions for filing the REMIC's annual return are determined as if the REMIC were a partnership.

(2) *Income tax return.* The REMIC must make a return, as required by section 6011(a), for each taxable year on Form 1066, U.S. Real Estate Mortgage Investment Conduit Income Tax Return. The return must include—

(i) The amount of principal outstanding on each class of regular interests as of the close of the taxable year,

(ii) The amount of the daily accruals determined under section 860E(c), and

(iii) The information specified in § 1.860D–1(d)(2) (i), (iv), and (v).

(c) *Signing of REMIC return*—(1) *In general.* Although a REMIC is generally treated as a partnership for purposes of subtitle F, for purposes of determining who is authorized to sign a REMIC's income tax return for any taxable year, the REMIC is not treated as a partnership and the holders of residual interests in the REMIC are not treated as partners. Rather, the REMIC return must be signed by a person who could sign the return of the entity absent the REMIC election. Thus, the return of a REMIC that is a corporation or trust under applicable State law must be signed by a corporate officer or a trustee, respectively. The return of a REMIC that consists of a segregated pool of assets must be signed by a person who could sign the return of the entity that owns the assets of the REMIC under applicable State law.

(2) *REMIC whose startup day is before November 10, 1988*—(i) *In general.* The income tax return of a REMIC whose startup day is before November 10, 1988, may be signed by any person who held a residual interest during the taxable year to which the return relates, or, as

provided in section 6903, by a fiduciary, as defined in section 7701(a)(6), who is acting for the REMIC and who has furnished adequate notice in the manner prescribed in § 301.6903–1(b) of this chapter.

(ii) *Startup day*. For purposes of paragraph (c)(2) of this section, startup day means any day selected by a REMIC that is on or before the first day on which interests in such REMIC are issued.

(iii) *Exception*. A REMIC whose startup day is before November 10, 1988, may elect to have paragraph (c)(1) of this section apply, instead of paragraph (c)(2) of this section, in determining who is authorized to sign the REMIC return. See section 1006(t)(18)(B) of the Technical and Miscellaneous Revenue Act of 1988 (102 Stat. 3426) and § 5h.6(a)(1) of this chapter for the time and manner for making this election.

(d) *Designation of tax matters person*. A REMIC may designate a tax matters person in the same manner in which a partnership may designate a tax matters partner under § 301.6231(a)(7)–1T of this chapter. For purposes of applying that section, all holders of residual interests in the REMIC are treated as general partners.

(e) *Notice to holders of residual interests*—(1) *Information required*. As of the close of each calendar quarter, a REMIC must provide to each person who held a residual interest in the REMIC during that quarter notice on Schedule Q (Form 1066) of information specified in paragraphs (e)(1) (i) and (ii) of this section.

(i) *In general*. Each REMIC must provide to each of its residual interest holders the following information—

(A) That person's share of the taxable income or net loss of the REMIC for the calendar quarter;

(B) The amount of the excess inclusion (as defined in section 860E and the regulations thereunder), if any, with respect to that person's residual interest for the calendar quarter;

(C) If the holder of a residual interest is also a pass-through interest holder (as defined in § 1.67–3T(a)(2)), the allocable investment expenses (as defined in § 1.67–3T(a)(4)) for the calendar quarter, and

(D) Any other information required by Schedule Q (Form 1066).

(ii) *Information with respect to REMIC assets*—(A) *95 percent asset test*. For calendar quarters after 1988, each REMIC must provide to each of its residual interest holders the following information—

(*1*) The percentage of REMIC assets that are qualifying real property loans under section 593,

(*2*) The percentage of REMIC assets that are assets described in section 7701(a)(19), and

(*3*) The percentage of REMIC assets that are real estate assets defined in section 856(c)(6)(B), computed by reference to the average adjusted basis (as defined in section 1011) of the REMIC assets during the calendar quarter (as described in paragraph (e)(1)(iii) of this section). If the percentage of REMIC assets represented by a category is at least 95 percent, then the REMIC need only specify that the percentage for that category was at least 95 percent.

(B) *Additional information required if the 95 percent test not met*. If, for any calendar quarter after 1988, less than 95 percent of the assets of the REMIC are real estate assets defined in section 856(c)(6)(B), then, for that calendar quarter, the REMIC must also provide to any real estate investment trust (REIT) that holds a residual interest the following information—

(*1*) The percentage of REMIC assets described in section 856(c)(5)(A), computed by reference to the average adjusted basis of the REMIC assets during the calendar quarter (as described in paragraph (e)(1)(iii) of this section),

(*2*) The percentage of REMIC gross income (other than gross income from prohibited transactions defined in section 860F(a)(2)) described in section 856(c)(3)(A) through (E), computed as of the close of the calendar quarter, and

(*3*) The percentage of REMIC gross income (other than gross income from prohibited transactions defined in section 860F(a)(2)) described in section 856(c)(3)(F), computed as of the close of the calendar quarter. For purposes of this paragraph (e)(1)(ii)(B)(*3*), the term ''foreclosure property'' contained in section 856(c)(3)(F) has the meaning specified in section 860G(a)(8).

In determining whether a REIT satisfies the limitations of section 856(c)(2), all REMIC gross income is deemed to be derived from a source specified in section 856(c)(2).

(C) *For calendar quarters in 1987.* For calendar quarters in 1987, the percentages of assets required in paragraphs (e)(1)(ii) (A) and (B) of this section may be computed by reference to the fair market value of the assets of the REMIC as of the close of the calendar quarter (as described in paragraph (e)(1)(iii) of this section), instead of by reference to the average adjusted basis during the calendar quarter.

(D) *For calendar quarters in 1988 and 1989.* For calendar quarters in 1988 and 1989, the percentages of assets required in paragraphs (e)(1)(ii) (A) and (B) of this section may be computed by reference to the average fair market value of the assets of the REMIC during the calendar quarter (as described in paragraph (e)(1)(iii) of this section), instead of by reference to the average adjusted basis of the assets of the REMIC during the calendar quarter.

(iii) *Special provisions.* For purposes of paragraph (e)(1)(ii) of this section, the percentage of REMIC assets represented by a specified category computed by reference to average adjusted basis (or fair market value) of the assets during a calendar quarter is determined by dividing the average adjusted bases (or for calendar quarters before 1990, fair market value) of the assets in the specified category by the average adjusted basis (or, for calendar quarters before 1990, fair market value) of all the assets of the REMIC as of the close of each month, week, or day during that calendar quarter. The monthly, weekly, or daily computation period must be applied uniformly during the calendar quarter to all categories of assets and may not be changed in succeeding calendar quarters without the consent of the Commissioner.

(2) *Quarterly notice required*—(i) *In general.* Schedule Q must be mailed (or otherwise delivered) to each holder of a residual interest during a calendar quarter no later than the last day of the month following the close of the calendar quarter.

(ii) *Special rule for 1987.* Notice to any holder of a REMIC residual interest of the information required in paragraph (e)(1) of this section for any of the four calendar quarters of 1987 must be mailed (or otherwise delivered) to each holder no later than March 28, 1988.

(3) *Nominee reporting*—(i) *In general.* If a REMIC is required under paragraphs (e) (1) and (2) of this section to provide notice to an interest holder who is a nominee of another person with respect to an interest in the REMIC, the nominee must furnish that notice to the person for whom it is a nominee.

(ii) *Time for furnishing statement.* The nominee must furnish the notice required under paragraph (e)(3)(i) of this section to the person for whom it is a nominee no later than 30 days after receiving this information.

(4) *Reports to the Internal Revenue Service.* For each person who was a residual interest holder at any time during a REMIC's taxable year, the REMIC must attach a copy of Schedule Q to its income tax return for that year for each quarter in which that person was a residual interest holder. Quarterly notice to the Internal Revenue Service is not required.

(f) *Information returns for persons engaged in a trade or business.* See § 1.6041–1(b)(2) for the treatment of a REMIC under sections 6041 and 6041A.

[T.D. 8366, 56 FR 49516, Sept. 30, 1991, as amended by T.D. 8458, 57 FR 61306, Dec. 24, 1992; 58 FR 8098, Feb. 11, 1993; T.D. 9184, 70 FR 9219, Feb. 25, 2005]

§ 1.860G–1 Definition of regular and residual interests.

(a) *Regular interest*—(1) *Designation as a regular interest.* For purposes of section 860G(a)(1), a REMIC designates an interest as a regular interest by providing to the Internal Revenue Service the information specified in § 1.860D–1(d)(2)(ii) in the time and manner specified in § 1.860D–1(d)(2).

(2) *Specified portion of the interest payments on qualified mortgages*—(i) *In general.* For purposes of section 860G(a)(1)(B)(ii), a specified portion of the interest payments on qualified mortgages means a portion of the interest payable on qualified mortgages, but only if the portion can be expressed as—

(A) A fixed percentage of the interest that is payable at either a fixed rate or

at a variable rate described in paragraph (a)(3) of this section on some or all of the qualified mortgages;

(B) A fixed number of basis points of the interest payable on some or all of the qualified mortgages; or

(C) The interest payable at either a fixed rate or at a variable rate described in paragraph (a)(3) of this section on some or all of the qualified mortgages in excess of a fixed number of basis points or in excess of a variable rate described in paragraph (a)(3) of this section.

(ii) *Specified portion cannot vary.* The portion must be established as of the startup day (as defined in section 860G(a)(9) and §1.860G–2(k)) and, except as provided in paragraph (a)(2)(iii) of this section, it cannot vary over the period that begins on the startup day and ends on the day that the interest holder is no longer entitled to receive payments.

(iii) *Defaulted or delinquent mortgages.* A portion is not treated as varying over time if an interest holder's entitlement to a portion of the interest on some or all of the qualified mortgages is dependent on the absence of defaults or delinquencies on those mortgages.

(iv) *No minimum specified principal amount is required.* If an interest in a REMIC consists of a specified portion of the interest payments on the REMIC's qualified mortgages, no minimum specified principal amount need be assigned to that interest. The specified principal amount can be zero.

(v) *Specified portion includes portion of interest payable on regular interest.* (A) The specified portions that meet the requirements of paragraph (a)(2)(i) of this section include a specified portion that can be expressed as a fixed percentage of the interest that is payable on some or all of the qualified mortgages where—

(*1*) Each of those qualified mortgages is a regular interest issued by another REMIC; and

(*2*) With respect to that REMIC in which it is a regular interest, each of those regular interests bears interest that can be expressed as a specified portion as described in paragraph (a)(2)(i)(A), (B), or (C) of this section.

(B) See §1.860A–1(a) for the effective date of this paragraph (a)(2)(v).

(vi) *Examples.* The following examples, each of which describes a passthru trust that is intended to qualify as a REMIC, illustrate the provisions of this paragraph (a)(2).

Example 1. (i) A sponsor transferred a pool of fixed rate mortgages to a trustee in exchange for two classes of certificates. The Class A certificate holders are entitled to all principal payments on the mortgages and to interest on outstanding principal at a variable rate based on the current value of One-Month LIBOR, subject to a lifetime cap equal to the weighted average rate payable on the mortgages. The Class B certificate holders are entitled to all interest payable on the mortgages in excess of the interest paid on the Class A certificates. The Class B certificates are subordinate to the Class A certificates so that cash flow shortfalls due to defaults or delinquencies on the mortgages will be borne first by the Class B certificate holders.

(ii) The Class B certificate holders are entitled to all interest payable on the pooled mortgages in excess of a variable rate described in paragraph (a)(3)(vi) of this section. Moreover, the portion of the interest payable to the Class B certificate holders is not treated as varying over time solely because payments on the Class B certificates may be reduced as a result of defaults or delinquencies on the pooled mortgages. Thus, the Class B certificates provide for interest payments that consist of a specified portion of the interest payable on the pooled mortgages under paragraph (a)(2)(i)(C) of this section.

Example 2. (i) A sponsor transferred a pool of variable rate mortgages to a trustee in exchange for two classes of certificates. The mortgages call for interest payments at a variable rate based on the current value of the One-Year Constant Maturity Treasury Index (hereinafter ''CMTI'') plus 200 basis points, subject to a lifetime cap of 12 percent. Class C certificate holders are entitled to all principal payments on the mortgages and interest on the outstanding principal at a variable rate based on the One-Year CMTI plus 100 basis points, subject to a lifetime cap of 12 percent. The interest rate on the Class C certificates is reset at the same time the rate is reset on the pooled mortgages.

(ii) The Class D certificate holders are entitled to all interest payments on the mortgages in excess of the interest paid on the Class C certificates. So long as the One-Year CMTI is at 10 percent or lower, the Class D certificate holders are entitled to 100 basis points of interest on the pooled mortgages. If, however, the index exceeds 10 percent on a reset date, the Class D certificate holders' entitlement shrinks, and it disappears if the index is at 11 percent or higher.

(iii) The Class D certificate holders are entitled to all interest payable on the pooled

mortgages in excess of a qualified variable rate described in paragraph (a)(3) of this section. Thus, the Class D certificates provide for interest payments that consist of a specified portion of the interest payable on the qualified mortgages under paragraph (a)(2)(i)(C) of this section.

Example 3. (i) A sponsor transferred a pool of fixed rate mortgages to a trustee in exchange for two classes of certificates. The fixed interest rate payable on the mortgages varies from mortgage to mortgage, but all rates are between 8 and 10 percent. The Class E certificate holders are entitled to receive all principal payments on the mortgages and interest on outstanding principal at 7 percent. The Class F certificate holders are entitled to receive all interest on the mortgages in excess of the interest paid on the Class E certificates.

(ii) The Class F certificates provide for interest payments that consist of a specified portion of the interest payable on the mortgages under paragraph (a)(2)(i) of this section. Although the portion of the interest payable to the Class F certificate holders varies from mortgage to mortgage, the interest payable can be expressed as a fixed percentage of the interest payable on each particular mortgage.

(3) *Variable rate.* A regular interest may bear interest at a variable rate. For purposes of section 860G(a)(1)(B)(i), a variable rate of interest is a rate described in this paragraph (a)(3).

(i) *Rate based on current interest rate.* A qualified floating rate as defined in §1.1275–5(b)(1) (but without the application of paragraph (b)(2) or (3) of that section) set at a current value, as defined in §1.1275–5(a)(4), is a variable rate. In addition, a rate equal to the highest, lowest, or average of two or more qualified floating rates is a variable rate. For example, a rate based on the average cost of funds of one or more financial institutions is a variable rate.

(ii) *Weighted average rate*—(A) *In general.* A rate based on a weighted average of the interest rates on some or all of the qualified mortgages held by a REMIC is a variable rate. The qualified mortgages taken into account must, however, bear interest at a fixed rate or at a rate described in this paragraph (a)(3). Generally, a weighted average interest rate is a rate that, if applied to the aggregate outstanding principal balance of a pool of mortgage loans for an accrual period, produces an amount of interest that equals the sum of the interest payable on the pooled loans for that accrual period. Thus, for an accrual period in which a pool of mortgage loans comprises $300,000 of loans bearing a 7 percent interest rate and $700,000 of loans bearing a 9.5 percent interest rate, the weighted average rate for the pool of loans is 8.75 percent.

(B) *Reduction in underlying rate.* For purposes of paragraph (a)(3)(ii)(A) of this section, an interest rate is considered to be based on a weighted average rate even if, in determining that rate, the interest rate on some or all of the qualified mortgages is first subject to a cap or a floor, or is first reduced by a number of basis points or a fixed percentage. A rate determined by taking a weighted average of the interest rates on the qualified mortgage loans net of any servicing spread, credit enhancement fees, or other expenses of the REMIC is a rate based on a weighted average rate for the qualified mortgages. Further, the amount of any rate reduction described above may vary from mortgage to mortgage.

(iii) *Additions, subtractions, and multiplications.* A rate is a variable rate if it is—

(A) Expressed as the product of a rate described in paragraph (a)(3)(i) or (ii) of this section and a fixed multiplier;

(B) Expressed as a constant number of basis points more or less than a rate described in paragraph (a)(3)(i) or (ii) of this section; or

(C) Expressed as the product, plus or minus a constant number of basis points, of a rate described in paragraph (a)(3)(i) or (ii) of this section and a fixed multiplier (which may be either a positive or a negative number).

(iv) *Caps and floors.* A rate is a variable rate if it is a rate that would be described in paragraph (a)(3)(i) through (iii) of this section except that it is—

(A) Limited by a cap or ceiling that establishes either a maximum rate or a maximum number of basis points by which the rate may increase from one accrual or payment period to another or over the term of the interest; or

(B) Limited by a floor that establishes either a minimum rate or a maximum number of basis points by which the rate may decrease from one accrual

or payment period to another or over the term of the interest.

(v) *Funds-available caps*—(A) *In general*. A rate is a variable rate if it is a rate that would be described in paragraph (a)(3)(i) through (iv) of this section except that it is subject to a ''funds-available'' cap. A funds-available cap is a limit on the amount of interest to be paid on an instrument in any accrual or payment period that is based on the total amount available for the distribution, including both principal and interest received by an issuing entity on some or all of its qualified mortgages as well as amounts held in a reserve fund. The term ''funds-available cap'' does not, however, include any cap or limit on interest payments used as a device to avoid the standards of paragraph (a)(3)(i) through (iv) of this section.

(B) *Facts and circumstances test*. In determining whether a cap or limit on interest payments is a funds-available cap within the meaning of this section and not a device used to avoid the standards of paragraph (a)(3)(i) through (iv) of this section, one must consider all of the facts and circumstances. Facts and circumstances that must be taken into consideration are—

(*1*) Whether the rate of the interest payable to the regular interest holders is below the rate payable on the REMIC's qualified mortgages on the start-up day; and

(*2*) Whether, historically, the rate of interest payable to the regular interest holders has been consistently below that payable on the qualified mortgages.

(C) *Examples*. The following examples, both of which describe a pass-thru trust that is intended to qualify as a REMIC, illustrate the provisions of this paragraph (a)(3)(v).

Example 1. (i) A sponsor transferred a pool of mortgages to a trustee in exchange for two classes of certificates. The pool of mortgages has an aggregate principal balance of $100*x*. Each mortgage in the pool provides for interest payments based on the eleventh district cost of funds index (hereinafter COFI) plus a margin. The initial weighted average rate for the pool is COFI plus 200 basis points. The trust issued a Class X certificate that has a principal amount of $100*x* and that provides for interest payments at a rate equal to One-Year LIBOR plus 100 basis points, subject to a cap described below. The Class R certificate, which the sponsor designated as the residual interest, entitles its holder to all funds left in the trust after the Class X certificates have been retired. The Class R certificate holder is not entitled to current distributions.

(ii) At the time the certificates were issued, COFI equalled 4.874 percent and One-Year LIBOR equalled 3.375 percent. Thus, the initial weighted average pool rate was 6.874 percent and the Class X certificate rate was 4.375 percent. Based on historical data, the sponsor does not expect the rate paid on the Class X certificate to exceed the weighted average rate on the pool.

(iii) Initially, under the terms of the trust instrument, the excess of COFI plus 200 over One-Year LIBOR plus 100 (excess interest) will be applied to pay expenses of the trust, to fund any required reserves, and then to reduce the principal balance on the Class X certificate. Consequently, although the aggregate principal balance of the mortgages initially matched the principal balance of the Class X certificate, the principal balance on the Class X certificate will pay down faster than the principal balance on the mortgages as long as the weighted average rate on the mortgages is greater than One-Year LIBOR plus 100. If, however, the rate on the Class X certificate (One-Year LIBOR plus 100) ever exceeds the weighted average rate on the mortgages, then the Class X certificate holders will receive One-Year LIBOR plus 100 subject to a cap based on the current funds that are available for distribution.

(iv) The funds available cap here is not a device used to avoid the standards of paragraph (a)(3) (i) through (iv) of this section. First, on the date the Class X certificates were issued, a significant spread existed between the weighted average rate payable on the mortgages and the rate payable on the Class X certificate. Second, historical data suggest that the weighted average rate payable on the mortgages will continue to exceed the rate payable on the Class X certificate. Finally, because the excess interest will be applied to reduce the outstanding principal balance of the Class X certificate more rapidly than the outstanding principal balance on the mortgages is reduced, One-Year LIBOR plus 100 basis points would have to exceed the weighted average rate on the mortgages by an increasingly larger amount before the funds available cap would be triggered. Accordingly, the rate paid on the Class X certificates is a variable rate.

Example 2. (i) The facts are the same as those in *Example 1*, except that the pooled mortgages are commercial mortgages that provide for interest payments based on the gross profits of the mortgagors, and the rate on the Class X certificates is 400 percent on One-Year LIBOR (a variable rate under paragraph (a)(3)(iii) of this section), subject to a

cap equal to current funds available to the trustee for distribution.

(ii) Initially, 400 percent of One-Year LIBOR exceeds the weighted average rate payable on the mortgages. Furthermore, historical data suggest that there is a significant possibility that, in the future, 400 percent of One-Year LIBOR will exceed the weighted average rate on the mortgages.

(iii) The facts and circumstances here indicate that the use of 400 percent of One-Year LIBOR with the above-described cap is a device to pass through to the Class X certificate holder contingent interest based on mortgagor profits. Consequently, the rate paid on the Class X certificate here is not a variable rate.

(vi) *Combination of rates.* A rate is a variable rate if it is based on—

(A) One fixed rate during one or more accrual or payment periods and a different fixed rate or rates, or a rate or rates described in paragraph (a)(3) (i) through (v) of this section, during other accrual or payment periods; or

(B) A rate described in paragraph (a)(3) (i) through (v) of this section during one or more accrual or payment periods and a fixed rate or rates, or a different rate or rates described in paragraph (a)(3) (i) through (v) of this section in other periods.

(4) *Fixed terms on the startup day.* For purposes of section 860G(a)(1), a regular interest in a REMIC has fixed terms on the startup day if, on the startup day, the REMIC's organizational documents irrevocably specify—

(i) The principal amount (or other similar amount) of the regular interest;

(ii) The interest rate or rates used to compute any interest payments (or other similar amounts) on the regular interest; and

(iii) The latest possible maturity date of the interest.

(5) *Contingencies prohibited.* Except for the contingencies specified in paragraph (b)(3) of this section, the principal amount (or other similar amount) and the latest possible maturity date of the interest must not be contingent.

(b) *Special rules for regular interests*—(1) *Call premium.* An interest in a REMIC does not qualify as a regular interest if the terms of the interest entitle the holder of that interest to the payment of any premium that is determined with reference to the length of time that the regular interest is outstanding and is not described in paragraph (b)(2) of this section.

(2) *Customary prepayment penalties received with respect to qualified mortgages.* An interest in a REMIC does not fail to qualify as a regular interest solely because the REMIC's organizational documents provide that the REMIC must allocate among and pay to its regular interest holders any customary prepayment penalties that the REMIC receives with respect to its qualified mortgages. Moreover, a REMIC may allocate prepayment penalties among its classes of interests in any manner specified in the REMIC's organizational documents. For example, a REMIC could allocate all or substantially all of a prepayment penalty that it receives to holders of an interest-only class of interests because that class would be most significantly affected by prepayments.

(3) *Certain contingencies disregarded.* An interest in a REMIC does not fail to qualify as a regular interest solely because it is issued subject to some or all of the contingencies described in paragraph (b)(3) (i) through (vi) of this section.

(i) *Prepayments, income, and expenses.* An interest does not fail to qualify as a regular interest solely because—

(A) The timing of (but not the right to or amount of) principal payments (or other similar amounts) is affected by the extent of prepayments on some or all of the qualified mortgages held by the REMIC or the amount of income from permitted investments (as defined in § 1.860G–2(g)); or

(B) The timing of interest and principal payments is affected by the payment of expenses incurred by the REMIC.

(ii) *Credit losses.* An interest does not fail to qualify as a regular interest solely because the amount or the timing of payments of principal or interest (or other similar amounts) with respect to a regular interest is affected by defaults on qualified mortgages and permitted investments, unanticipated expenses incurred by the REMIC, or lower than expected returns on permitted investments.

(iii) *Subordinated interests.* An interest does not fail to qualify as a regular interest solely because that interest

bears all, or a disproportionate share, of the losses stemming from cash flow shortfalls due to defaults or delinquencies on qualified mortgages or permitted investments, unanticipated expenses incurred by the REMIC, lower than expected returns on permitted investments, or prepayment interest shortfalls before other regular interests or the residual interest bear losses occasioned by those shortfalls.

(iv) *Deferral of interest.* An interest does not fail to qualify as a regular interest solely because that interest, by its terms, provides for deferral of interest payments.

(v) *Prepayment interest shortfalls.* An interest does not fail to qualify as a regular interest solely because the amount of interest payments is affected by prepayments of the underlying mortgages.

(vi) *Remote and incidental contingencies.* An interest does not fail to qualify as a regular interest solely because the amount or timing of payments of principal or interest (or other similar amounts) with respect to the interest is subject to a contingency if there is only a remote likelihood that the contingency will occur. For example, an interest could qualify as a regular interest even though full payment of principal and interest on that interest is contingent upon the absence of significant cash flow shortfalls due to the operation of the Soldiers and Sailors Civil Relief Act, 50 U.S.C. app. 526 (1988).

(4) *Form of regular interest.* A regular interest in a REMIC may be issued in the form of debt, stock, an interest in a partnership or trust, or any other form permitted by state law. If a regular interest in a REMIC is not in the form of debt, it must, except as provided in paragraph (a)(2)(iv) of this section, entitle the holder to a specified amount that would, were the interest issued in debt form, be identified as the principal amount of the debt.

(5) *Interest disproportionate to principal*—(i) *In general.* An interest in a REMIC does not qualify as a regular interest if the amount of interest (or other similar amount) payable to the holder is disproportionately high relative to the principal amount or other specified amount described in paragraph (b)(4) of this section (specified principal amount). Interest payments (or other similar amounts) are considered disproportionately high if the issue price (as determined under paragraph (d) of this section) of the interest in the REMIC exceeds 125 percent of its specified principal amount.

(ii) *Exception.* A regular interest in a REMIC that entitles the holder to interest payments consisting of a specified portion of interest payments on qualified mortgages qualifies as a regular interest even if the amount of interest is disproportionately high relative to the specified principal amount.

(6) *Regular interest treated as a debt instrument for all Federal income tax purposes.* In determining the tax under chapter 1 of the Internal Revenue Code, a REMIC regular interest (as defined in section 860G(a)(1)) is treated as a debt instrument that is an obligation of the REMIC. Thus, sections 1271 through 1288, relating to bonds and other debt instruments, apply to a regular interest. For special rules relating to the accrual of original issue discount on regular interests, see section 1272(a)(6).

(c) *Residual interest.* A residual interest is an interest in a REMIC that is issued on the startup day and that is designated as a residual interest by providing the information specified in §1.860D–1(d)(2)(ii) at the time and in the manner provided in §1.860D–1(d)(2). A residual interest need not entitle the holder to any distributions from the REMIC.

(d) *Issue price of regular and residual interests*—(1) *In general.* The issue price of any REMIC regular or residual interest is determined under section 1273(b) as if the interest were a debt instrument and, if issued for property, as if the requirements of section 1273(b)(3) were met. Thus, if a class of interests is publicly offered, then the issue price of an interest in that class is the initial offering price to the public at which a substantial amount of the class is sold. If the interest is in a class that is not publicly offered, the issue price is the price paid by the first buyer of that interest regardless of the price paid for the remainder of the class. If the interest is in a class that is retained by the sponsor, the issue price is its fair market value on the

pricing date (as defined in §1.860F–2(b)(3)(iii)), if any, or, if none, the startup day, regardless of whether the property exchanged therefor is publicly traded.

(2) *The public*. The term ''the public'' for purposes of this section does not include brokers or other middlemen, nor does it include the sponsor who acquires all of the regular and residual interests from the REMIC on the startup day in a transaction described in §1.860F–2(a).

[T.D. 8458, 57 FR 61306, Dec. 24, 1992; 58 FR 8098, Feb. 11, 1993; 58 FR 15089, Mar. 19, 1993; T.D. 8614, 60 FR 42787, Aug. 17, 1995]

§ 1.860G–2 Other rules.

(a) *Obligations principally secured by an interest in real property*—(1) *Tests for determining whether an obligation is principally secured*. For purposes of section 860G(a)(3)(A), an obligation is principally secured by an interest in real property only if it satisfies either the test set out in paragraph (a)(1)(i) or the test set out in paragraph (a)(1)(ii) of this section.

(i) *The 80-percent test*. An obligation is principally secured by an interest in real property if the fair market value of the interest in real property securing the obligation—

(A) Was at least equal to 80 percent of the adjusted issue price of the obligation at the time the obligation was originated (see paragraph (b)(1) of this section concerning the origination date for obligations that have been significantly modified); or

(B) Is at least equal to 80 percent of the adjusted issue price of the obligation at the time the sponsor contributes the obligation to the REMIC.

(ii) *Alternative test*. For purposes of section 860G(a)(3)(A), an obligation is principally secured by an interest in real property if substantially all of the proceeds of the obligation were used to acquire or to improve or protect an interest in real property that, at the origination date, is the only security for the obligation. For purposes of this test, loan guarantees made by the United States or any state (or any political subdivision, agency, or instrumentality of the United States or of any state), or other third party credit enhancement are not viewed as additional security for a loan. An obligation is not considered to be secured by property other than real property solely because the obligor is personally liable on the obligation.

(2) *Treatment of liens*. For purposes of paragraph (a)(1)(i) of this section, the fair market value of the real property interest must be first reduced by the amount of any lien on the real property interest that is senior to the obligation being tested, and must be further reduced by a proportionate amount of any lien that is in parity with the obligation being tested.

(3) *Safe harbor*—(i) *Reasonable belief that an obligation is principally secured*. If, at the time the sponsor contributes an obligation to a REMIC, the sponsor reasonably believes that the obligation is principally secured by an interest in real property within the meaning of paragraph (a)(1) of this section, then the obligation is deemed to be so secured for purposes of section 860G(a)(3). A sponsor cannot avail itself of this safe harbor with respect to an obligation if the sponsor actually knows or has reason to know that the obligation fails both of the tests set out in paragraph (a)(1) of this section.

(ii) *Basis for reasonable belief*. For purposes of paragraph (a)(3)(i) of this section, a sponsor may base a reasonable belief concerning any obligation on—

(A) Representations and warranties made by the originator of the obligation; or

(B) Evidence indicating that the originator of the obligation typically made mortgage loans in accordance with an established set of parameters, and that any mortgage loan originated in accordance with those parameters would satisfy at least one of the tests set out in paragraph (a)(1) of this section.

(iii) *Later discovery that an obligation is not principally secured*. If, despite the sponsor's reasonable belief concerning an obligation at the time it contributed the obligation to the REMIC, the REMIC later discovers that the obligation is not principally secured by an interest in real property, the obligation is a defective obligation and loses its status as a qualified mortgage 90 days

after the date of discovery. See paragraph (f) of this section, relating to defective obligations.

(4) *Interests in real property; real property*. The definition of ''interests in real property'' set out in § 1.856–3(c), and the definition of ''real property'' set out in § 1.856–3(d), apply to define those terms for purposes of section 860G(a)(3) and paragraph (a) of this section.

(5) *Obligations secured by an interest in real property*. Obligations secured by interests in real property include the following: mortgages, deeds of trust, and installment land contracts; mortgage pass-thru certificates guaranteed by GNMA, FNMA, FHLMC, or CMHC (Canada Mortgage and Housing Corporation); other investment trust interests that represent undivided beneficial ownership in a pool of obligations principally secured by interests in real property and related assets that would be considered to be permitted investments if the investment trust were a REMIC, and provided the investment trust is classified as a trust under § 301.7701–4(c) of this chapter; and obligations secured by manufactured housing treated as single family residences under section 25(e)(10) (without regard to the treatment of the obligations or the properties under state law).

(6) *Obligations secured by other obligations; residual interests*. Obligations (other than regular interests in a REMIC) that are secured by other obligations are not principally secured by interests in real property even if the underlying obligations are secured by interests in real property. Thus, for example, a collateralized mortgage obligation issued by an issuer that is not a REMIC is not an obligation principally secured by an interest in real property. A residual interest (as defined in section 860G(a)(2)) is not an obligation principally secured by an interest in real property.

(7) *Certain instruments that call for contingent payments are obligations*. For purposes of section 860G(a)(3) and (4), the term ''obligation'' includes any instrument that provides for total noncontingent principal payments that at least equal the instrument's issue price even if that instrument also provides for contingent payments. Thus, for example, an instrument that was issued for $100*x* and that provides for noncontingent principal payments of $100*x*, interest payments at a fixed rate, and contingent payments based on a percentage of the mortgagor's gross receipts, is an obligation.

(8) *Release of a lien on an interest in real property securing a qualified mortgage; defeasance*. If a REMIC releases its lien on an interest in real property that secures a qualified mortgage, that mortgage ceases to be a qualified mortgage on the date the lien is released unless—

(i) The REMIC releases its lien in a modification that—

(A) Either is not a significant modification as defined in paragraph (b)(2) of this section or is one of the listed exceptions set forth in paragraph (b)(3) of this section; and

(B) Following that modification, the obligation continues to be principally secured by an interest in real property as determined by paragraph (b)(7) of this section; or

(ii) The mortgage is defeased in the following manner—

(A) The mortgagor pledges substitute collateral that consists solely of government securities (as defined in section 2(a)(16) of the Investment Company Act of 1940 as amended *(15 U.S.C. 80a–1)*);

(B) The mortgage documents allow such a substitution;

(C) The lien is released to facilitate the disposition of the property or any other customary commercial transaction, and not as part of an arrangement to collateralize a REMIC offering with obligations that are not real estate mortgages; and

(D) The release is not within 2 years of the startup day.

(9) *Stripped bonds and coupons*. The term ''qualified mortgage'' includes stripped bonds and stripped coupons (as defined in section 1286(e) (2) and (3)) if the bonds (as defined in section 1286(e)(1)) from which such stripped bonds or stripped coupons arose would have been qualified mortgages.

(b) *Assumptions and modifications*—(1) *Significant modifications are treated as exchanges of obligations*. If an obligation is significantly modified in a manner or under circumstances other than those described in paragraph (b)(3) of

this section, then the modified obligation is treated as one that was newly issued in exchange for the unmodified obligation that it replaced. Consequently—

(i) If such a significant modification occurs after the obligation has been contributed to the REMIC and the modified obligation is not a qualified replacement mortgage, the modified obligation will not be a qualified mortgage and the deemed disposition of the unmodified obligation will be a prohibited transaction under section 860F(a)(2); and

(ii) If such a significant modification occurs before the obligation is contributed to the REMIC, the modified obligation will be viewed as having been originated on the date the modification occurs for purposes of the tests set out in paragraph (a)(1) of this section.

(2) *Significant modification defined.* For purposes of paragraph (b)(1) of this section, a ''significant modification'' is any change in the terms of an obligation that would be treated as an exchange of obligations under section 1001 and the related regulations.

(3) *Exceptions.* For purposes of paragraph (b)(1) of this section, the following changes in the terms of an obligation are not significant modifications regardless of whether they would be significant modifications under paragraph (b)(2) of this section—

(i) Changes in the terms of the obligation occasioned by default or a reasonably foreseeable default;

(ii) Assumption of the obligation;

(iii) Waiver of a due-on-sale clause or a due-on-encumbrance clause;

(iv) Conversion of an interest rate by a mortgagor pursuant to the terms of a convertible mortgage;

(v) A modification that releases, substitutes, adds, or otherwise alters a substantial amount of the collateral for, a guarantee on, or other form of credit enhancement for, a recourse or nonrecourse obligation, so long as the obligation continues to be principally secured by an interest in real property following the release, substitution, addition, or other alteration as determined by paragraph (b)(7) of this section; and

(vi) A change in the nature of the obligation from recourse (or substantially all recourse) to nonrecourse (or substantially all nonrecourse), or from nonrecourse (or substantially all nonrecourse) to recourse (or substantially all recourse), so long as the obligation continues to be principally secured by an interest in real property following such a change as determined by paragraph (b)(7) of this section.

(4) *Modifications that are not significant modifications.* If an obligation is modified and the modification is not a significant modification for purposes of paragraph (b)(1) of this section, then the modified obligation is not treated as one that was newly originated on the date of modification.

(5) *Assumption defined.* For purposes of paragraph (b)(3) of this section, a mortgage has been assumed if—

(i) The buyer of the mortgaged property acquires the property subject to the mortgage, without assuming any personal liability;

(ii) The buyer becomes liable for the debt but the seller also remains liable; or

(iii) The buyer becomes liable for the debt and the seller is released by the lender.

(6) *Pass-thru certificates.* If a REMIC holds as a qualified mortgage a pass-thru certificate or other investment trust interest of the type described in paragraph (a)(5) of this section, the modification of a mortgage loan that backs the pass-thru certificate or other interest is not a modification of the pass-thru certificate or other interest unless the investment trust structure was created to avoid the prohibited transaction rules of section 860F(a).

(7) *Test for determining whether an obligation continues to be principally secured following certain types of modifications.* (i) For purposes of paragraphs (a)(8)(i), (b)(3)(v), and (b)(3)(vi) of this section, the obligation continues to be principally secured by an interest in real property following the modification only if, as of the date of the modification, the obligation satisfies either paragraph (b)(7)(ii) or paragraph (b)(7)(iii) of this section.

(ii) The fair market value of the interest in real property securing the obligation, determined as of the date of the modification, must be at least 80 percent of the adjusted issue price of

the modified obligation, determined as of the date of the modification. If, as of the date of the modification, the servicer reasonably believes that the obligation satisfies the criterion in the preceding sentence, then the obligation is deemed to do so. A reasonable belief does not exist if the servicer actually knows, or has reason to know, that the criterion is not satisfied. For purposes of this paragraph (b)(7)(ii), a servicer must base a reasonable belief on—

(A) A current appraisal performed by an independent appraiser;

(B) An appraisal that was obtained in connection with the origination of the obligation and, if appropriate, that has been updated for the passage of time and for any other changes that might affect the value of the interest in real property;

(C) The sales price of the interest in real property in the case of a substantially contemporary sale in which the buyer assumes the seller's obligations under the mortgage; or

(D) Some other commercially reasonable valuation method.

(iii) If paragraph (b)(7)(ii) of this section is not satisfied, the fair market value of the interest in real property that secures the obligation immediately after the modification must equal or exceed the fair market value of the interest in real property that secured the obligation immediately before the modification. The criterion in the preceding sentence must be established by a current appraisal, an original (and updated) appraisal, or some other commercially reasonable valuation method; and the servicer must not actually know, or have reason to know, that the criterion in the preceding sentence is not satisfied.

(iv) *Example.* The following example illustrates the rules of this paragraph (b)(7).

Example. (i) S services mortgage loans that are held by R, a REMIC. Borrower B is the issuer of one of the mortgage loans held by R. The original amount of B's mortgage loan was $100,000, and the loan was secured by real property X. At the time the loan was contributed to R, property X had a fair market value of $90,000. Sometime after the loan was contributed to R, B experienced financial difficulties such that it was reasonably foreseeable that B might default on the loan if the loan was not modified. Accordingly, S altered various terms of B's loan to substantially reduce the risk of default. The alterations included the release of the lien on property X and the substitution of real property Y for property X as collateral for the loan. At the time the loan was modified, its adjusted issue price was $100,000. The fair market value of property X immediately before the modification (as determined by a commercially reasonable valuation method) was $70,000, and the fair market value of property Y immediately after the modification (as determined by a commercially reasonable valuation method) was $75,000.

(ii) The alterations to B's loan are a significant modification within the meaning of §1.1001–3(e). The modification, however, is described in paragraphs (a)(8)(i) and (b)(3) of this section. Accordingly, the modified loan continues to be a qualified mortgage if, immediately after the modification, the modified loan continues to be principally secured by an interest in real property, as determined by paragraph (b)(7) of this section.

(iii) Because the modification includes the release of the lien on property X and substitution of property Y for property X, the modified loan must satisfy paragraph (b)(7)(i) of this section (which requires satisfaction of either paragraph (b)(7)(ii) or paragraph (b)(7)(iii) of this section). The modified loan does not satisfy paragraph (b)(7)(ii) of this section because property Y is worth less than $80,000 (the amount equal to 80 percent of the adjusted issue price of the modified mortgage loan). The modified loan, however, satisfies paragraph (b)(7)(iii) of this section because the fair market value of the interest in real estate (real property Y) that secures the obligation immediately after the modification ($75,000) exceeds the fair market value of the interest in real estate (real property X) that secured the obligation immediately before the modification ($70,000). Accordingly, the modified loan satisfies paragraph (b)(7)(i) of this section and continues to be principally secured by an interest in real property.

(c) *Treatment of certain credit enhancement contracts*—(1) *In general.* A credit enhancement contract (as defined in paragraph (c) (2) and (3) of this section) is not treated as a separate asset of the REMIC for purposes of the asset test set out in section 860D(a)(4) and §1.860D–1(b)(3), but instead is treated as part of the mortgage or pool of mortgages to which it relates. Furthermore, any collateral supporting a credit enhancement contract is not treated as an asset of the REMIC solely because it supports the guarantee represented by that contract. See paragraph (g)(1)(ii) of this section for the treatment of

payments made pursuant to credit enhancement contracts as payments received under a qualified mortgage.

(2) *Credit enhancement contracts.* For purposes of this section, a credit enhancement contract is any arrangement whereby a person agrees to guarantee full or partial payment of the principal or interest payable on a qualified mortgage or on a pool of such mortgages, or full or partial payment on one or more classes of regular interests or on the class of residual interests, in the event of defaults or delinquencies on qualified mortgages, unanticipated losses or expenses incurred by the REMIC, or lower than expected returns on cash flow investments. Types of credit enhancement contracts may include, but are not limited to, pool insurance contracts, certificate guarantee insurance contracts, letters of credit, guarantees, or agreements whereby the REMIC sponsor, a mortgage servicer, or other third party agrees to make advances described in paragraph (c)(3) of this section.

(3) *Arrangements to make certain advances.* The arrangements described in this paragraph (c)(3) are credit enhancement contracts regardless of whether, under the terms of the arrangement, the payor is obligated, or merely permitted, to advance funds to the REMIC.

(i) *Advances of delinquent principal and interest.* An arrangement by a REMIC sponsor, mortgage servicer, or other third party to advance to the REMIC out of its own funds an amount to make up for delinquent payments on qualified mortgages is a credit enhancement contract.

(ii) *Advances of taxes, insurance payments, and expenses.* An arrangement by a REMIC sponsor, mortgage servicer, or other third party to pay taxes and hazard insurance premiums on, or other expenses incurred to protect the REMIC's security interest in, property securing a qualified mortgage in the event that the mortgagor fails to pay such taxes, insurance premiums, or other expenses is a credit enhancement contract.

(iii) *Advances to ease REMIC administration.* An agreement by a REMIC sponsor, mortgage servicer, or other third party to advance temporarily to a REMIC amounts payable on qualified mortgages before such amounts are actually due to level out the stream of cash flows to the REMIC or to provide for orderly administration of the REMIC is a credit enhancement contract. For example, if two mortgages in a pool have payment due dates on the twentieth of the month, and all the other mortgages have payment due dates on the first of each month, an agreement by the mortgage servicer to advance to the REMIC on the fifteenth of each month the payments not yet received on the two mortgages together with the amounts received on the other mortgages is a credit enhancement contract.

(4) *Deferred payment under a guarantee arrangement.* A guarantee arrangement does not fail to qualify as a credit enhancement contract solely because the guarantor, in the event of a default on a qualified mortgage, has the option of immediately paying to the REMIC the full amount of mortgage principal due on acceleration of the defaulted mortgage, or paying principal and interest to the REMIC according to the original payment schedule for the defaulted mortgage, or according to some other deferred payment schedule. Any deferred payments are payments pursuant to a credit enhancement contract even if the mortgage is foreclosed upon and the guarantor, pursuant to subrogation rights set out in the guarantee arrangement, is entitled to receive immediately the proceeds of foreclosure.

(d) *Treatment of certain purchase agreements with respect to convertible mortgages*—(1) *In general.* For purposes of sections 860D(a)(4) and 860G(a)(3), a purchase agreement (as described in paragraph (d)(3) of this section) with respect to a convertible mortgage (as described in paragraph (d)(5) of this section) is treated as incidental to the convertible mortgage to which it relates. Consequently, the purchase agreement is part of the mortgage or pool of mortgages and is not a separate asset of the REMIC.

(2) *Treatment of amounts received under purchase agreements.* For purposes of sections 860A through 860G and for purposes of determining the accrual of

original issue discount and market discount under sections 1272(a)(6) and 1276, respectively, a payment under a purchase agreement described in paragraph (d)(3) of this section is treated as a prepayment in full of the mortgage to which it relates. Thus, for example, a payment under a purchase agreement with respect to a qualified mortgage is considered a payment received under a qualified mortgage within the meaning of section 860G(a)(6) and the transfer of the mortgage is not a disposition of the mortgage within the meaning of section 860F(a)(2)(A).

(3) *Purchase agreement.* A purchase agreement is a contract between the holder of a convertible mortgage and a third party under which the holder agrees to sell and the third party agrees to buy the mortgage for an amount equal to its current principal balance plus accrued but unpaid interest if and when the mortgagor elects to convert the terms of the mortgage.

(4) *Default by the person obligated to purchase a convertible mortgage.* If the person required to purchase a convertible mortgage defaults on its obligation to purchase the mortgage upon conversion, the REMIC may sell the mortgage in a market transaction and the proceeds of the sale will be treated as amounts paid pursuant to a purchase agreement.

(5) *Convertible mortgage.* A convertible mortgage is a mortgage that gives the obligor the right at one or more times during the term of the mortgage to elect to convert from one interest rate to another. The new rate of interest must be determined pursuant to the terms of the instrument and must be intended to approximate a market rate of interest for newly originated mortgages at the time of the conversion.

(e) *Prepayment interest shortfalls.* An agreement by a mortgage servicer or other third party to make payments to the REMIC to make up prepayment interest shortfalls is not treated as a separate asset of the REMIC and payments made pursuant to such an agreement are treated as payments on the qualified mortgages. With respect to any mortgage that prepays, the prepayment interest shortfall for the accrual period in which the mortgage prepays is an amount equal to the excess of the interest that would have accrued on the mortgage during that accrual period had it not prepaid, over the interest that accrued from the beginning of that accrual period up to the date of the prepayment.

(f) *Defective obligations*—(1) *Defective obligation defined.* For purposes of sections 860G(a)(4)(B)(ii) and 860F(a)(2), a defective obligation is a mortgage subject to any of the following defects.

(i) The mortgage is in default, or a default with respect to the mortgage is reasonably foreseeable.

(ii) The mortgage was fraudulently procured by the mortgagor.

(iii) The mortgage was not in fact principally secured by an interest in real property within the meaning of paragraph (a)(1) of this section.

(iv) The mortgage does not conform to a customary representation or warranty given by the sponsor or prior owner of the mortgage regarding the characteristics of the mortgage, or the characteristics of the pool of mortgages of which the mortgage is a part. A representation that payments on a qualified mortgage will be received at a rate no less than a specified minimum or no greater than a specified maximum is not customary for this purpose.

(2) *Effect of discovery of defect.* If a REMIC discovers that an obligation is a defective obligation, and if the defect is one that, had it been discovered before the startup day, would have prevented the obligation from being a qualified mortgage, then, unless the REMIC either causes the defect to be cured or disposes of the defective obligation within 90 days of discovering the defect, the obligation ceases to be a qualified mortgage at the end of that 90 day period. Even if the defect is not cured, the defective obligation is, nevertheless, a qualified mortgage from the startup day through the end of the 90 day period. Moreover, even if the REMIC holds the defective obligation beyond the 90 day period, the REMIC may, nevertheless, exchange the defective obligation for a qualified replacement mortgage so long as the requirements of section 860G(a)(4)(B) are satisfied. If the defect is one that does not affect the status of an obligation as a qualified mortgage, then the obligation

is always a qualified mortgage regardless of whether the defect is or can be cured. For example, if a sponsor represented that all mortgages transferred to a REMIC had a 10 percent interest rate, but it was later discovered that one mortgage had a 9 percent interest rate, the 9 percent mortgage is defective, but the defect does not affect the status of that obligation as a qualified mortgage.

(g) *Permitted investments*—(1) *Cash flow investment*—(i) *In general*. For purposes of section 860G(a)(6) and this section, a cash flow investment is an investment of payments received on qualified mortgages for a temporary period between receipt of those payments and the regularly scheduled date for distribution of those payments to REMIC interest holders. Cash flow investments must be passive investments earning a return in the nature of interest.

(ii) *Payments received on qualified mortgages*. For purposes of paragraph (g)(1) of this section, the term ''payments received on qualified mortgages'' includes—

(A) Payments of interest and principal on qualified mortgages, including prepayments of principal and payments under credit enhancement contracts described in paragraph (c)(2) of this section;

(B) Proceeds from the disposition of qualified mortgages;

(C) Cash flows from foreclosure property and proceeds from the disposition of such property;

(D) A payment by a sponsor or prior owner in lieu of the sponsor's or prior owner's repurchase of a defective obligation, as defined in paragraph (f) of this section, that was transferred to the REMIC in breach of a customary warranty; and

(E) Prepayment penalties required to be paid under the terms of a qualified mortgage when the mortgagor prepays the obligation.

(iii) *Temporary period*. For purposes of section 860G(a)(6) and this paragraph (g)(1), a temporary period generally is that period from the time a REMIC receives payments on qualified mortgages and permitted investments to the time the REMIC distributes the payments to interest holders. A temporary period may not exceed 13 months. Thus, an investment held by a REMIC for more than 13 months is not a cash flow investment. In determining the length of time that a REMIC has held an investment that is part of a commingled fund or account, the REMIC may employ any reasonable method of accounting. For example, if a REMIC holds mortgage cash flows in a commingled account pending distribution, the first-in, first-out method of accounting is a reasonable method for determining whether all or part of the account satisfies the 13 month limitation.

(2) *Qualified reserve funds*. The term qualified reserve fund means any reasonably required reserve to provide for full payment of expenses of the REMIC or amounts due on regular or residual interests in the event of defaults on qualified mortgages, prepayment interest shortfalls (as defined in paragraph (e) of this section), lower than expected returns on cash flow investments, or any other contingency that could be provided for under a credit enhancement contract (as defined in paragraph (c) (2) and (3) of this section).

(3) *Qualified reserve asset*—(i) *In general*. The term ''qualified reserve asset'' means any intangible property (other than a REMIC residual interest) that is held both for investment and as part of a qualified reserve fund. An asset need not generate any income to be a qualified reserve asset.

(ii) *Reasonably required reserve*—(A) *In general*. In determining whether the amount of a reserve is reasonable, it is appropriate to consider the credit quality of the qualified mortgages, the extent and nature of any guarantees relating to either the qualified mortgages or the regular and residual interests, the expected amount of expenses of the REMIC, and the expected availability of proceeds from qualified mortgages to pay the expenses. To the extent that a reserve exceeds a reasonably required amount, the amount of the reserve must be promptly and appropriately reduced. If at any time, however, the amount of the reserve fund is less than is reasonably required, the amount of the reserve fund may be increased by the addition of

payments received on qualified mortgages or by contributions from holders of residual interests.

(B) *Presumption that a reserve is reasonably required.* The amount of a reserve fund is presumed to be reasonable (and an excessive reserve is presumed to have been promptly and appropriately reduced) if it does not exceed the amount required by a third party insurer or guarantor, who does not own directly or indirectly (within the meaning of section 267(c)) an interest in the REMIC (as defined in § 1.860D–1(b)(1)), as a condition of providing credit enhancement.

(C) *Presumption may be rebutted.* The presumption in paragraph (g)(3)(ii)(B) of this section may be rebutted if the amounts required by the third party insurer are not commercially reasonable considering the factors described in paragraph (g)(3)(ii)(A) of this section.

(D) *Applicability date.* Paragraphs (g)(3)(ii)(B) and (g)(3)(ii)(C) of this section apply on and after July 6, 2011.

(h) *Outside reserve funds.* A reserve fund that is maintained to pay expenses of the REMIC, or to make payments to REMIC interest holders is an outside reserve fund and not an asset of the REMIC only if the REMIC's organizational documents clearly and expressly—

(1) Provide that the reserve fund is an outside reserve fund and not an asset of the REMIC;

(2) Identify the owner(s) of the reserve fund, either by name, or by description of the class (*e.g.*, subordinated regular interest holders) whose membership comprises the owners of the fund; and

(3) Provide that, for all Federal tax purposes, amounts transferred by the REMIC to the fund are treated as amounts distributed by the REMIC to the designated owner(s) or transferees of the designated owner(s).

(i) *Contractual rights coupled with regular interests in tiered arrangements*—(1) *In general.* If a REMIC issues a regular interest to a trustee of an investment trust for the benefit of the trust certificate holders and the trustee also holds for the benefit of those certificate holders certain other contractual rights, those other rights are not treated as assets of the REMIC even if the investment trust and the REMIC were created contemporaneously pursuant to a single set of organizational documents. The organizational documents must, however, require that the trustee account for the contractual rights as property that the trustee holds separate and apart from the regular interest.

(2) *Example.* The following example, which describes a tiered arrangement involving a pass-thru trust that is intended to qualify as a REMIC and a pass-thru trust that is intended to be classified as a trust under § 301.7701–4(c) of this chapter, illustrates the provisions of paragraph (i)(1) of this section.

Example. (i) A sponsor transferred a pool of mortgages to a trustee in exchange for two classes of certificates. The pool of mortgages has an aggregate principal balance of $100*x*. Each mortgage in the pool provides for interest payments based on the eleventh district cost of funds index (hereinafter COFI) plus a margin. The trust (hereinafter REMIC trust) issued a Class N bond, which the sponsor designates as a regular interest, that has a principal amount of $100*x* and that provides for interest payments at a rate equal to One-Year LIBOR plus 100 basis points, subject to a cap equal to the weighted average pool rate. The Class R interest, which the sponsor designated as the residual interest, entitles its holder to all funds left in the trust after the Class N bond has been retired. The Class R interest holder is not entitled to current distributions.

(ii) On the same day, and under the same set of documents, the sponsor also created an investment trust. The sponsor contributed to the investment trust the Class N bond together with an interest rate cap contract. Under the interest rate cap contract, the issuer of the cap contract agrees to pay to the trustee for the benefit of the investment trust certificate holders the excess of One-Year LIBOR plus 100 basis points over the weighted average pool rate (COFI plus a margin) times the outstanding principal balance of the Class N bond in the event One-Year LIBOR plus 100 basis points ever exceeds the weighted average pool rate. The trustee (the same institution that serves as REMIC trust trustee), in exchange for the contributed assets, gave the sponsor certificates representing undivided beneficial ownership interests in the Class N bond and the interest rate cap contract. The organizational documents require the trustee to account for the regular interest and the cap contract as discrete property rights.

(iii) The separate existence of the REMIC trust and the investment trust are respected

for all Federal income tax purposes. Thus, the interest rate cap contract is an asset beneficially owned by the several certificate holders and is not an asset of the REMIC trust. Consequently, each certificate holder must allocate its purchase price for the certificate between its undivided interest in the Class N bond and its undivided interest in the interest rate cap contract in accordance with the relative fair market values of those two property rights.

(j) *Clean-up call*—(1) *In general*. For purposes of section 860F(a)(5)(B), a clean-up call is the redemption of a class of regular interests when, by reason of prior payments with respect to those interests, the administrative costs associated with servicing that class outweigh the benefits of maintaining the class. Factors to consider in making this determination include—

(i) The number of holders of that class of regular interests;

(ii) The frequency of payments to holders of that class;

(iii) The effect the redemption will have on the yield of that class of regular interests;

(iv) The outstanding principal balance of that class; and

(v) The percentage of the original principal balance of that class still outstanding.

(2) *Interest rate changes*. The redemption of a class of regular interests undertaken to profit from a change in interest rates is not a clean-up call.

(3) *Safe harbor*. Although the outstanding principal balance is only one factor to consider, the redemption of a class of regular interests with an outstanding principal balance of no more than 10 percent of its original principal balance is always a clean-up call.

(k) *Startup day*. The term ''startup day'' means the day on which the REMIC issues all of its regular and residual interests. A sponsor may, however, contribute property to a REMIC in exchange for regular and residual interests over any period of 10 consecutive days and the REMIC may designate any one of those 10 days as its startup day. The day so designated is then the startup day, and all interests are treated as issued on that day.

[T.D. 8458, 57 FR 61309, Dec. 24, 1992; 58 FR 8098, Feb. 11, 1993; T.D. 9463, 74 FR 47438, Sept. 16, 2009; T.D. 9533, 76 FR 39282, July 6, 2011; T.D. 9637, 78 FR 54760, Sept. 6, 2013]

§ 1.860G–3 Treatment of foreign persons.

(a) *Transfer of a residual interest with tax avoidance potential*—(1) *In general*. A transfer of a residual interest that has tax avoidance potential is disregarded for all Federal tax purposes if the transferee is a foreign person. Thus, if a residual interest with tax avoidance potential is transferred to a foreign holder at formation of the REMIC, the sponsor is liable for the tax on any excess inclusion that accrues with respect to that residual interest.

(2) *Tax avoidance potential*—(i) *Defined*. A residual interest has tax avoidance potential for purposes of this section unless, at the time of the transfer, the transferor reasonably expects that, for each excess inclusion, the REMIC will distribute to the transferee residual interest holder an amount that will equal at least 30 percent of the excess inclusion, and that each such amount will be distributed at or after the time at which the excess inclusion accrues and not later than the close of the calendar year following the calendar year of accrual.

(ii) *Safe harbor*. For purposes of paragraph (a)(2)(i) of this section, a transferor has a reasonable expectation if the 30-percent test would be satisfied were the REMIC's qualified mortgages to prepay at each rate within a range of rates from 50 percent to 200 percent of the rate assumed under section 1272(a)(6) with respect to the qualified mortgages (or the rate that would have been assumed had the mortgages been issued with original issue discount).

(3) *Effectively connected income*. Paragraph (a)(1) of this section will not apply if the transferee's income from the residual interest is subject to tax under section 871(b) or section 882.

(4) *Transfer by a foreign holder*. If a foreign person transfers a residual interest to a United States person or a foreign holder in whose hands the income from a residual interest would be effectively connected income, and if the transfer has the effect of allowing the transferor to avoid tax on accrued excess inclusions, then the transfer is disregarded and the transferor continues to be treated as the owner of the residual interest for purposes of section 871(a), 881, 1441, or 1442.

(b) *Accounting for REMIC net income*—(1) *Allocation of partnership income to a foreign partner.* A domestic partnership shall separately state its allocable share of REMIC taxable income or net loss in accordance with § 1.702–1(a)(8). If a domestic partnership allocates all or some portion of its allocable share of REMIC taxable income to a partner that is a foreign person, the amount allocated to the foreign partner shall be taken into account by the foreign partner for purposes of sections 871(a), 881, 1441, and 1442 as if that amount was received on the last day of the partnership's taxable year, except to the extent that some or all of the amount is required to be taken into account by the foreign partner at an earlier time under section 860G(b) as a result of a distribution by the partnership to the foreign partner or a disposition of the foreign partner's indirect interest in the REMIC residual interest. A disposition in whole or in part of the foreign partner's indirect interest in the REMIC residual interest may occur as a result of a termination of the REMIC, a disposition of the partnership's residual interest in the REMIC, a disposition of the foreign partner's interest in the partnership, or any other reduction in the foreign partner's allocable share of the portion of the REMIC net income or deduction allocated to the partnership. See § 1.871–14(d)(2) for the treatment of interest received on a regular or residual interest in a REMIC. For a partnership's withholding obligations with respect to excess inclusion amounts described in this paragraph (b)(1), see §§ 1.1441–2(b)(5), 1.1441–2(d)(4), 1.1441–5(b)(2)(i)(A), and §§ 1.1446–1 through 1.1446–7.

(2) *Excess inclusion income allocated by certain pass-through entities to a foreign person.* If an amount is allocated under section 860E(d)(1) to a foreign person that is a shareholder of a real estate investment trust or a regulated investment company, a participant in a common trust fund, or a patron of an organization to which part I of subchapter T applies and if the amount so allocated is governed by section 860E(d)(2) (treating it ''as an excess inclusion with respect to a residual interest held by'' the taxpayer), the amount shall be taken into account for purposes of sections 871(a), 881, 1441, and 1442 at the same time as the time prescribed for other income of the shareholder, participant, or patron from the trust, company, fund, or organization.

[T.D. 8458, 57 FR 61313, Dec. 24, 1992, as amended by T.D. 9272, 71 FR 43365, Aug. 1, 2006; T.D. 9415, 73 FR 40172, July 14, 2008]

TAX BASED ON INCOME FROM SOURCES WITHIN OR WITHOUT THE UNITED STATES

DETERMINATION OF SOURCES OF INCOME

§ 1.861–1 Income from sources within the United States.

(a) *Categories of income.* Part I (section 861 and following), subchapter N, chapter 1 of the Code, and the regulations thereunder determine the sources of income for purposes of the income tax. These sections explicitly allocate certain important sources of income to the United States or to areas outside the United States, as the case may be; and, with respect to the remaining income (particularly that derived partly from sources within and partly from sources without the United States), authorize the Secretary or his delegate to determine the income derived from sources within the United States, either by rules of separate allocation or by processes or formulas of general apportionment. The statute provides for the following three categories of income:

(1) *Within the United States.* The gross income from sources within the United States, consisting of the items of gross income specified in section 861(a) plus the items of gross income allocated or apportioned to such sources in accordance with section 863(a). See §§ 1.861–2 to 1.861–7, inclusive, and § 1.863–1. The taxable income from sources within the United States, in the case of such income, shall be determined by deducting therefrom, in accordance with sections 861(b) and 863(a), the expenses, losses, and other deductions properly apportioned or allocated thereto and a ratable part of any other expenses, losses, or deductions which cannot definitely be allocated to some item or class of gross income. See §§ 1.861–8 and 1.863–1.

(2) *Without the United States.* The gross income from sources without the

United States, consisting of the items of gross income specified in section 862(a) plus the items of gross income allocated or apportioned to such sources in accordance with section 863(a). See §§ 1.862–1 and 1.863–1. The taxable income from sources without the United States, in the case of such income, shall be determined by deducting therefrom, in accordance with sections 862(b) and 863(a), the expenses, losses, and other deductions properly apportioned or allocated thereto and a ratable part of any other expenses, losses, or deductions which cannot definitely be allocated to some item or class of gross income. See §§ 1.862–1 and 1.863–1.

(3) *Partly within and partly without the United States.* The gross income derived from sources partly within and partly without the United States, consisting of the items specified in section 863(b) (1), (2), and (3). The taxable income allocated or apportioned to sources within the United States, in the case of such income, shall be determined in accordance with section 863 (a) or (b). See §§ 1.863–2 to 1.863–5, inclusive.

(4) *Exceptions.* An owner of certain aircraft or vessels first leased on or before December 28, 1980, may elect to treat income in respect of these aircraft or vessels as income from sources within the United States for purposes of sections 861(a) and 862(a). See § 1.861–9. An owner of certain aircraft, vessels, or spacecraft first leased after December 28, 1980, must treat income in respect of these craft as income from sources within the United States for purposes of sections 861(a) and 862(a). See § 1.861–9A.

(b) *Taxable income from sources within the United States.* The taxable income from sources within the United States shall consist of the taxable income described in paragraph (a)(1) of this section plus the taxable income allocated or apportioned to such sources, as indicated in paragraph (a)(3) of this section.

(c) *Computation of income.* If a taxpayer has gross income from sources within or without the United States, together with gross income derived partly from sources within and partly from sources without the United States, the amounts thereof, together with the expenses and investment applicable thereto, shall be segregated; and the taxable income from sources within the United States shall be separately computed therefrom.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 7928, 48 FR 55845, Dec. 16, 1983]

§ 1.861–2 Interest.

(a) *In general.* (1) Gross income consisting of interest from the United States or any agency or instrumentality thereof (other than a possession of the United States or an agency or instrumentality of a possession), a State or any political subdivision thereof, or the District of Columbia, and interest from a resident of the United States on a bond, note, or other interest-bearing obligation issued, assumed or incurred by such person shall be treated as income from sources within the United States. Thus, for example, income from sources within the United States includes interest received on any refund of income tax imposed by the United States, a State or any political subdivision thereof, or the District of Columbia. Interest other than that described in this paragraph is not to be treated as income from sources within the United States. See paragraph (a)(7) of this section for special rules concerning substitute interest paid or accrued pursuant to a securities lending transaction.

(2) The term ''resident of the United States'', as used in this paragraph, includes (i) an individual who at the time of payment of the interest is a resident of the United States, (ii) a domestic corporation, (iii) a domestic partnership which at any time during its taxable year is engaged in trade or business in the United States, or (iv) a foreign corporation or a foreign partnership, which at any time during its taxable year is engaged in trade or business in the United States.

(3) The method by which, or the place where, payment of the interest is made is immaterial in determining whether interest is derived from sources within the United States.

(4) For purposes of this section, the term ''interest'' includes all amounts treated as interest under section 483, and the regulations thereunder. It also

includes original issue discount, as defined in section 1232(b)(1), whether or not the underlying bond, debenture, note, certificate, or other evidence of indebtedness is a capital asset in the hands of the taxpayer within the meaning of section 1221.

(5) If interest is paid on an obligation of a resident of the United States by a nonresident of the United States acting in the nonresident's capacity as a guarantor of the obligation of the resident, the interest will be treated as income from sources within the United States.

(6) In the case of interest received by a nonresident alien individual or foreign corporation this paragraph (a) applies whether or not the interest is effectively connected for the taxable year with the conduct of a trade or business in the United States by such individual or corporation.

(7) A substitute interest payment is a payment, made to the transferor of a security in a securities lending transaction or a sale-repurchase transaction, of an amount equivalent to an interest payment which the owner of the transferred security is entitled to receive during the term of the transaction. A securities lending transaction is a transfer of one or more securities that is described in section 1058(a) or a substantially similar transaction. A sale-repurchase transaction is an agreement under which a person transfers a security in exchange for cash and simultaneously agrees to receive a substantially identical securities from the transferee in the future in exchange for cash. A substitute interest payment shall be sourced in the same manner as the interest accruing on the transferred security for purposes of this section and § 1.862–1. See also §§ 1.864–5(b)(2)(iii), 1.871–7(b)(2), 1.881–2(b)(2) and for the character of such payments and § 1.894–1(c) for the application tax treaties to these transactions.

(b) *Interest not derived from U.S. sources.* Notwithstanding paragraph (a) of this section, interest shall be treated as income from sources without the United States to the extent provided by subparagraphs (A) through (H), of section 861(a)(1) and by the following subparagraphs of this paragraph.

(1) *Interest on bank deposits and on similar amounts.* (i) Interest paid or credited before January 1, 1977, to a nonresident alien individual or foreign corporation on—

(*a*) Deposits with persons, including citizens of the United States or alien individuals and foreign or domestic partnerships or corporations, carrying on the banking business in the United States,

(*b*) Deposits or withdrawable accounts with savings institutions chartered and supervised as savings and loan or similar associations under Federal or State law, or

(*c*) Amounts held by an insurance company under an agreement to pay interest thereon, shall be treated as income from sources without the United States if such interest is not effectively connected for the taxable year with the conduct of a trade or business in the United States by such nonresident alien individual or foreign corporation. If such interest is effectively connected for the taxable year with the conduct of a trade or business in the United States by such nonresident alien individual or foreign corporation, it shall be treated as income from sources within the United States under paragraph (a) of this section unless it is treated as income from sources without the United States under another subparagraph of this paragraph. For a special rule for determining whether such interest is effectively connected for the taxable year with the conduct of a trade or business in the United States, see paragraph (c)(1)(ii) or § 1.864–4.

(ii) Paragraph (b)(1)(i)(*b*) of this section applies to interest on deposits or withdrawable accounts described therein only to the extent that the interest paid or credited by the savings institution described therein is deductible under section 591 in determining the taxable income of such institution; and, for this purpose, whether an amount is deductible under section 591 shall be determined without regard to section 265, relating to deductions allocable to tax-exempt income. Thus, for example, such subdivision does not apply to amounts paid by a savings and loan or similar association on or with respect to its nonwithdrawable capital

stock or on or with respect to funds held in restricted accounts which represent a proprietary interest in such association. Paragraph (b)(1)(i)(*b*) of this section also applies to so-called dividends paid or credited on deposits or withdrawable accounts if such dividends are deductible under section 591 without reference to section 265.

(iii) For purposes of paragraph (b)(1)(i)(*c*) of this section, amounts held by an insurance company under an agreement to pay interest thereon include policyholder dividends left with the company to accumulate, prepaid insurance premiums, proceeds of policies left on deposit with the company, and overcharges of premiums. Such subdivision does not apply to (*a*) the so-called ''interest element'' in the case of annuity or installment payments under life insurance or endowment contracts or (*b*) interest paid by an insurance company to its creditors on notes, bonds, or similar evidences of indebtedness, if the debtor-creditor relationship does not arise by virtue of a contract of insurance with the insurance company.

(iv) For purposes of paragraph (b)(1)(i) of this section, interest received by a partnership shall be treated as received by each partner of such partnership to the extent of his distributive share of such item.

(2) *Interest from a resident alien individual or domestic corporation deriving substantial income from sources without the United States.* Interest received from a resident alien individual or a domestic corporation shall be treated as income from sources without the United States when it is shown to the satisfaction of the district director (or, if applicable, the Director of International Operations) that less than 20 percent of the gross income from all sources of such individual or corporation has been derived from sources within the United States, as determined under the provisions of sections 861 to 863, inclusive, and the regulations thereunder, for the 3-year period ending with the close of the taxable year of such individual or corporation preceding its taxable year in which such interest is paid or credited, or for such part of such period as may be applicable. If 20 percent or more of the gross income from all sources of such individual or corporation has been derived from sources within the United States, as so determined, for such 3-year period (or part thereof), the entire amount of the interest from such individual or corporation shall be treated as income from sources within the United States.

(3) *Interest from a foreign corporation not deriving major portion of its income from a U.S. business.* (i) Interest from a foreign corporation which, at any time during the taxable year, is engaged in trade or business in the United States shall be treated as income from sources without the United States when it is shown to the satisfaction of the district director (or, if applicable, the Director of International Operations) that (*a*) less than 50 percent of the gross income from all sources of such foreign corporation for the 3-year period ending with the close of its taxable year preceding its taxable year in which such interest is paid or credited (or for such part of such period as the corporation has been in existence) was effectively connected with the conduct by such corporation of a trade or business in the United States, as determined under section 864(c) and § 1.864–3, or (*b*) such foreign corporation had gross income for such 3-year period (or part thereof) but none was effectively connected with the conduct of a trade or business in the United States.

(ii) If 50 percent or more of the gross income from all sources of such foreign corporation for such 3-year period (or part thereof) was effectively connected with the conduct by such corporation of a trade or business in the United States, see section 861(a)(1)(D) and paragraph (c)(1) of this section for determining the portion of interest from such corporation which is treated as income from sources within the United States.

(iii) For purposes of this paragraph the gross income which is effectively connected with the conduct of a trade or business in the United States includes the gross income which, pursuant to section 882 (d) or (e) and the regulations thereunder, is treated as income which is effectively connected with the conduct of a trade or business in the United States.

(iv) This paragraph does not apply to interest paid or credited after December 31, 1969, by a branch in the United States of a foreign corporation if, at the time of payment or crediting, such branch is engaged in the commercial banking business in the United States; furthermore, such interest is treated under paragraph (a) of this section as income from sources within the United States unless it is treated as income from sources without the United States under paragraph (b) (1) or (4) of this section.

(4) *Bankers' acceptances.* Interest derived by a foreign central bank of issue from bankers' acceptances shall be treated as income from sources without the United States. For this purpose, a foreign central bank of issue is a bank which is by law or government sanction the principal authority, other than the government itself, issuing instruments intended to circulate as currency. Such a bank is generally the custodian of the banking reserves of the country under whose laws it is organized.

(5) *Foreign banking branch of a domestic corporation or partnership.* Interest paid or credited on deposits with a branch outside the United States (as defined in section 7701(a)(9)) of a domestic corporation or of a domestic partnership shall be treated as income from sources without the United States, if, at the time of payment or crediting, such branch is engaged in the commercial banking business. For purposes of applying this paragraph, it is immaterial (i) whether the domestic corporation or domestic partnership is carrying on a banking business in the United States, (ii) whether the recipient of the interest is a citizen or resident of the United States, a foreign corporation, or a foreign partnership, (iii) whether the interest is effectively connected with the conduct of a trade or business in the United States by the recipient, or (iv) whether the deposits with the branch located outside the United States are payable in the currency of a foreign country. Notwithstanding the provisions of § 1.863–6, interest to which this paragraph applies shall be treated as income from sources within the foreign country, possession of the United States, or other territory in which the branch is located.

(6) *Section 4912(c) debt obligations*— (i) *In general.* Under section 861(a)(1)(G), interest on a debt obligation shall not be treated as income from sources within the United States if—

(*a*) The debt obligation was part of an issue of debt obligations with respect to which an election has been made under section 4912(c) (relating to the treatment of such debt obligations as debt obligations of a foreign obligor for purposes of the interest equalization tax),

(*b*) The debt obligation had a maturity not exceeding 15 years (within the meaning of paragraph (b)(6)(ii) of this section) on the date it is originally issued or on the date it is treated under section 4912(c)(2) as issued by reason of being assumed by a certain domestic corporation,

(*c*) The debt obligation, when originally issued, was purchased by one or more underwriters (within the meaning of paragraph (b)(6)(iii) of this section) with a view to distribution through resale (within the meaning of paragraph (b)(6)(iv) of this section), and

(*d*) The interest on the debt obligation is attributable to periods after the effective date of an election under section 4912(c) to treat such debt obligations as debt obligations of a foreign obligor for purposes of the interest equalization tax.

(ii) *Maturity not exceeding 15 years.* The date the debt obligation is issued or treated as issued is not included in the 15 year computation, but the date of maturity of the debt, obligation is included in such computation.

(iii) *Purchased by one or more underwriters.* For purposes of this paragraph, the debt obligation when originally issued will not be treated as purchased by one or more underwriters unless the underwriter purchases the debt obligation for his own account and bears the risk of gain or loss on resale. Thus, for example, a debt obligation, when originally issued, will not be treated as purchased by one or more underwriters if the underwriter acts only in the capacity of an agent of the issuer. Neither will a debt obligation, when originally issued, be treated as purchased by one or more underwriters if the agreement

between the underwriter and issuer is merely for a ''best efforts'' underwriting, for the purchase by the underwriter of all or a portion of the debt obligations remaining unsold at the expiration of a fixed period of time, or for any other arrangement under the terms of which the debt obligations are not purchased by the underwriter with a view to distribution through resale. The fact that an underwriter is related to the issuer will not prevent the underwriter from meeting the requirements of this paragraph. In determining whether a related underwriter meets the requirements of this paragraph consideration shall be given to whether the purchase by the underwriter of the debt obligation from the issuer for resale was effected by a transaction subject to conditions similar to those which would have been imposed between independent persons.

(iv) *With a view to distribution through resale.* (*a*) An underwriter who purchased a debt obligation shall be deemed to have purchased it with a view to distribution through resale if the requirements of paragraph (b)(6)(iv)(*b*) or (*c*) of this section are met.

(*b*) The requirements of this paragraph (*b*) is that—

(*1*) The debt obligation is registered, approved, or listed for trading on one or more foreign securities exchanges or foreign established securities markets within 4 months after the date on which the underwriter purchases the debt obligation, or by the date of the first interest payment on the debt obligation, whichever is later, or

(*2*) The debt obligation, or any substantial portion of the issue of which the debt obligation is a part, is actually traded on one or more foreign securities markets on or within 15 calendar days after the date on which the underwriter purchases the debt obligation.

For purposes of this paragraph (b)(6)(iv), a foreign established securities market includes any foreign over-the-counter market as reflected by the existence of an inter-dealer quotation system for regularly disseminating to brokers and dealers quotations of obligations by identified brokers or dealers, other than quotations prepared and distributed by a broker or dealer in the regular course of his business and containing only quotations of such broker or dealer.

(*c*) The requirements of this paragraph (*c*) are that, except as provided in paragraph (b)(6)(iv)(*d*) of this section, the underwriter is under no written or implied restriction imposed by the issuer with respect to whom he may resell the debt obligation and either—

(*1*) Within 30 calendar days after he purchased the debt obligation the underwriter or underwriters either (*i*) sold it or (*ii*) sold at least 95 percent of the face amount of the issue of which the debt obligation is a part, or

(*2*)(*i*) The debt obligation is evidenced by an instrument which, under the laws of the jurisdiction in which it is issued, is either negotiable or transferable by assignment (whether or not it is registered for trading), and (*ii*) it appears from all the relevant facts and circumstances, including any written statements or assurances made by the purchasing underwriter or underwriters, that such debt obligation was purchased with a view to distribution through resale.

(*d*) The requirements of paragraph (b)(6)(iv)(*c*) of this paragraph may be met whether or not the underwriter is restricted from reselling the debt obligations—

(*1*) To a United States person (as defined in section 7701(a)(30)) or

(*2*) To any particular person or persons pursuant to a restriction imposed by, or required to be met in order to comply with, United States or foreign securities or other law.

(v) *Statement with return.* Any taxpayer who is required to file a tax return and who excludes from gross income interest of the type specified in this subparagraph must comply with the requirements of paragraph (d) of this section.

(vi) *Effect of termination of IET.* If the interest equalization tax expires, the provisions of section 861(a)(1)(G) and this subparagraph shall apply to interest paid on debt obligations only with respect to which a section 4912(c) election was made.

(vii) *Definition of term underwriter.* For purposes of section 861(a)(1)(G) and

this paragraph, the term ''underwriter'' shall mean any underwriter as defined in section 4919(c)(1).

(c) *Special rules*—(1) *Proration of interest from a foreign corporation deriving major portion of its income from a U.S. business.* If, after applying the first sentence of paragraph (b)(3) of this section to interest to which that paragraph applies, it is determined that the interest may not be treated as income from sources without the United States, the amount of the interest from the foreign corporation which at some time during the taxable year is engaged in trade or business in the United States which is to be treated as income from sources within the United States shall be the amount that bears the same ratio to such interest as the gross income of such foreign corporation for the 3-year period ending with the close of its taxable year preceding its taxable year in which such interest is paid or credited (or for such part of such period as the corporation has been in existence) which was effectively connected with the conduct by such corporation of a trade or business in the United States bears to its gross income from all sources for such period.

(2) *Payors having no gross income for period preceding taxable year of payment.* If the resident alien individual, domestic corporation, or foreign corporation, as the case may be, paying interest has no gross income from any source for the 3-year period (or part thereof) specified in paragraph (b) (2) or (3) of this section, or paragraph (c)(1) of this section, the 20-percent test or the 50-percent test, or the apportionment formula, as the case may be, described in such paragraph shall be applied solely with respect to the taxable year of the payor in which the interest is paid or credited. This paragraph applies whether the lack of gross income for the 3-year period (or part thereof) stems from the business inactivity of the payor, from the fact that the payor is a corporation which is newly created or organized, or from any other cause.

(3) *Transitional rule.* For purposes of applying paragraph (b)(3) of this section, and paragraph (c)(1) of this section, the gross income of the foreign corporation for any period before the first taxable year beginning after December 31, 1966, which is from sources within the United States (determined as provided by sections 861 through 863, and the regulations thereunder, as in effect immediately before amendment by section 102 of the Foreign Investors Tax Act of 1966 (Pub. L. 89–809, 80 Stat. 1541)) shall be treated as gross income for such period which is effectively connected with the conduct of a trade or business in the United States by such foreign corporation.

(4) *Gross income determinations.* In making determinations under paragraph (b) (2) or (3) of this section, or paragraph (c) (1) or (3) of this section—

(i) The gross income of a domestic corporation or a resident alien individual is to be determined by excluding any items specifically excluded from gross income under chapter 1 of the Code, and

(ii) The gross income of a foreign corporation which is effectively connected with the conduct of a trade or business in the United States is to be determined under section 882(b)(2) and by excluding any items specifically excluded from gross income under chapter 1 of the Code, and

(iii) The gross income from all sources of a foreign corporation is to be determined without regard to section 882(b) and without excluding any items otherwise specifically excluded from gross income under chapter 1 of the Code.

(d) *Statement with return.* Any taxpayer who is required to file a return and applies any provision of this section to exclude an amount of interest from his gross income must file with his return a statement setting forth the amount so excluded, the date of its receipt, the name and address of the obligor of the interest, and, if known, the location of the records which substantiate the amount of the exclusion. A statement from the obligor setting forth such information and indicating the amount of interest to be treated as income from sources without the United States may be used for this purpose. See §§ 1.6012–1(b)(1)(i) and 1.6012–2(g)(1)(i).

(e) *Effective dates.* Except as otherwise provided, this section applies with respect to taxable years beginning

after December 31, 1966. For corresponding rules applicable to taxable years beginning before January 1, 1967, (see 26 CFR part 1 revised April 1, 1971). Paragraph (a)(7) of this section is applicable to payments made after November 13, 1997.

[T.D. 7378, 40 FR 45429, Oct. 2, 1975; 40 FR 48508, Oct. 16, 1975, as amended by T.D. 8257, 54 FR 31819, Aug. 2, 1989; T.D. 8735, 62 FR 53500, Oct. 14, 1997]

§ 1.861–3 Dividends.

(a) *General*—(1) *Dividends included in gross income.* Gross income from sources within the United States includes a dividend described in subparagraph (2), (3), (4), or (5) of this paragraph. For purposes of subparagraphs (2), (3), and (4) of this paragraph, the term ''dividend'' shall have the same meaning as set forth in section 316 and the regulations thereunder. See subparagraph (5) of this paragraph for special rules with respect to certain dividends from a DISC or former DISC. See also paragraph (a)(6) of this section for special rules concerning substitute dividend payments received pursuant to a securities lending transaction.

(2) *Dividend from a domestic corporation.* A dividend described in this paragraph (a)(2) is a dividend from a domestic corporation other than a corporation that has an election in effect under section 936. See paragraph (a)(5) of this section for the treatment of certain dividends from a DISC or former DISC.

(3) *Dividend from a foreign corporation*—(i) *In general*—(*a*) A dividend described in this subparagraph is a dividend from a foreign corporation (other than a dividend to which subparagraph (4) of this paragraph applies) unless less than 50 percent of the gross income from all sources of such foreign corporation for the 3-year period ending with the close of its taxable year preceding the taxable year in which occurs the declaration of such dividend (or for such part of such period as the corporation has been in existence) was effectively connected with the conduct by such corporation of a trade or business in the United States, as determined under section 864(c) and § 1.864–3. Thus, no portion of a dividend from a foreign corporation shall be treated as income from sources within the United States under section 861(a)(2)(B) if less than 50 percent of the gross income of such foreign corporation from all sources for such 3-year period (or part thereof) was effectively connected with the conduct by such corporation of a trade or business in the United States or if such foreign corporation had gross income for such 3-year period (or part thereof) but none was effectively connected with the conduct by such corporation of a trade or business in the United States.

(*b*) If 50 percent or more of the gross income from all sources of such foreign corporation for such 3-year period (or part thereof) was effectively connected with the conduct by such corporation of a trade or business in the United States, the amount of the dividend which is to be treated as income from sources within the United States under section 861(a)(2)(B) shall be the amount that bears the same ratio to such dividend as the gross income of such foreign corporation for such 3-year period (or part thereof) which was effectively connected with the conduct by such corporation of a trade or business in the United States bears to its gross income from all sources for such period.

(*c*) For purposes of this subdivision (i), the gross income which is effectively connected with the conduct of a trade or business in the United States includes the gross income which, pursuant to section 882 (d) or (e), is treated as income which is effectively connected with the conduct of a trade or business in the United States.

(ii) *Rule applicable in applying limitation on amount of foreign tax credit.* For purposes of determining under section 904 the limitation upon the amount of the foreign tax credit—

(*a*) So much of a dividend from a foreign corporation as exceeds (and only to the extent it so exceeds) the amount which is 100/85ths of the amount of the deduction allowable under section 245(a) in respect of such dividend, plus

(*b*) An amount which bears the same proportion to any section 78 dividend to which the dividend from the foreign corporation gives rise as the amount of the excess determined under (*a*) of this subdivision bears to the total amount

of the dividend from the foreign corporation, shall, notwithstanding subdivision (i) of this subparagraph, be treated as income from sources without the United States. This subdivision applies to a dividend for which no dividends-received deduction is allowed under section 245 or for which the 85 percent dividends-received deduction is allowed under section 245(a) but does not apply to a dividend for which a deduction is allowable under section 245(b). All of a dividend for which the 100 percent dividends-received deduction is allowed under section 245(b) shall be treated as income from sources within the United States for purposes of determining under section 904 the limitation upon the amount of the foreign tax credit. If the amount of a distribution of property other than money (constituting a dividend under section 316) is determined by applying section 301(b)(1)(C), such amount must be used as the dividend for purposes of applying (*a*) of this subdivision even though the amount used for purposes of section 245(a) is determined by applying section 301(b)(1)(D). In making determinations under this subdivision, a dividend (other than a section 78 dividend referred to in (*b*) of this subdivision) shall be determined without regard to section 78.

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

Example 1. D, a domestic corporation, owns 80 percent of the outstanding stock of M, a foreign manufacturing corporation. M, which makes its returns on the basis of the calendar year, has earnings and profits of $200,000 for 1971 and 60 percent of its gross income for that year is effectively connected for 1971 with the conduct of a trade or business in the United States. For an uninterrupted period of 36 months ending on December 31, 1970, M has been engaged in trade or business in the United States and has received gross income effectively connected with the conduct of a trade or business in the United States amounting to 60 percent of its gross income from all sources for such period. The only distribution by M to D for 1971 is a cash dividend of $100,000; of this amount, $60,000 ($100,000 × 60%) is treated under subdivision (i) of this subparagraph as income from sources within the United States, and $40,000 ($100,000 − $60,000) is treated under § 1.862–1(a)(2) as income from sources without the United States. Accordingly, under section 245(a), D is entitled to a dividends-received deduction of $51,000 ($60,000 × 85%), and under subdivision (ii) of this subparagraph $40,000 ($100,000 − [$51,000 × 100/85]) is treated as income from sources without the United States for purposes of determining under section 904(a) (1) or (2) the limitation upon the amount of the foreign tax credit.

Example 2. (a) The facts are the same as in example (1) except that the distribution for 1971 consists of property which has a fair market value of $100,000 and an adjusted basis of $30,000 in M's hands immediately before the distribution. The amount of the dividend under section 316 is $58,000, determined by applying section 301(b)(1)(C) as follows:

Portion of adjusted basis of property attributable to gross income of M effectively connected for 1971 with conduct of trade or business in United States ($30,000 × 60%)	$18,000
Portion of fair market value of property attributable to gross income of M not effectively connected for 1971 with conduct of trade or business in United States ($100,000 × 40%)	40,000
Total dividend	58,000

(b) Of the total dividend, $34,800 ($58,000 × 60% (percentage applicable to 3-year period)) is treated under subdivision (i) of this subparagraph as income from sources within the United States, and $23,200 ($58,000 × 40%) is treated under § 1.862–1(a)(2) as income from sources without the United States. However, by reason of section 245(c) the adjusted basis of the property ($30,000) is used under section 245(a) in determining the dividends-received deduction. Thus, under section 245(a), D is entitled to a dividends-received deduction of $15,300 ($30,000 × 60% × 85%).

(c) Under subdivision (ii) of this subparagraph, the amount of the dividend for purposes of applying (*a*) of that subdivision is the amount ($58,000) determined by applying section 301(b)(1)(C) rather than the amount ($30,000) determined by applying section 301(b)(1)(B). Accordingly, under subdivision (ii) of this subparagraph $40,000 ($58,000 − [$15,300 × 100/85]) is treated as income from sources without the United States for purposes of determining under section 904(a) (1) or (2) the limitation upon the amount of the foreign tax credit.

Example 3. (a) D, a domestic corporation which makes its returns on the basis of the calendar year, owns 100 percent of the outstanding stock of N, a foreign corporation which is not a less developed country corporation under section 902(d). N, which makes its returns on the basis of the calendar year, has total gross income for 1971 of $100,000, of which $80,000 (including $60,000 from sources within foreign country X) is effectively connected for that year with the conduct of a trade or business in the United States. For 1971 N is assumed to have paid $27,000 of income taxes to country X and to

have accumulated profits of $81,000 for purposes of section 902(c)(1)(A). N's accumulated profits in excess of foreign income taxes amount to $54,000. For 1971 D receives a cash dividend of $42,000 from N, which is D's only income for that year.

(b) For 1971 D chooses the benefits of the foreign tax credit under section 901, and as a result is required under section 78 to include in gross income an amount equal to the foreign income taxes of $21,000 ($27,000 × $42,000/$54,000) it is deemed to have paid under section 902(a)(1). Thus, assuming no other deductions for the taxable year, D has gross income of $63,000 ($42,000 + $21,000) for 1971 less a dividends-received deduction under section 245(a) of $28,560 ([$42,000 × $80,000/$100,000] × 85%), or taxable income for 1971 of $34,440.

(c) Under subdivision (ii) of this subparagraph, for purposes of determining under section 904(a) (1) or (2) the limitation upon the amount of the foreign tax credit, $12,600 is treated as income from sources without the United States, determined as follows:

Excess of dividend from N over amount which is 100/85ths of amount of sec. 245(a) deduction ($42,000 − [$28,560 × 100/85])	$8,400
Proportionate part of sec. 78 dividend ($21,000 × $8,400/$42,000)	4,200
Taxable income from sources without the United States	12,600

Example 4. A, an individual citizen of the United States who makes his return on the basis of the calendar year, receives in 1971 a cash dividend of $10,000 from M, a foreign corporation, which makes its return on the basis of the calendar year. For the 3-year period ending with 1970 M has been engaged in trade or business in the United States and has received gross income effectively connected with the conduct of a trade or business in the United States amounting to 80 percent of its gross income from all sources for such period. Of the total dividend, $8,000 ($10,000 × 80%) is treated under subdivision (i) of this subparagraph as income from sources within the United States and $2,000 ($10,000 − $8,000) is treated under §1.862–1(a)(2) as income from sources without the United States. Since under section 245 no dividends received-deduction is allowable to an individual, A is entitled under subdivision (ii) of this subparagraph to treat the entire dividend of $10,000 ($10,000 − [$0 × 100/85]) as income from sources without the United States for purposes of determining under section 904(a) (1) or (2) the limitation upon the amount of the foreign tax credit.

(4) *Dividend from a foreign corporation succeeding to earnings of a domestic corporation.* A dividend described in this subparagraph is a dividend from a foreign corporation, if such dividend is received by a corporation after December 31, 1959, but only to the extent that such dividend is treated by such recipient corporation under the provisions of §1.243–3 as a dividend from a domestic corporation subject to taxation under chapter 1 of the Code. To the extent that this subparagraph applies to a dividend received from a foreign corporation, subparagraph (3) of this paragraph shall not apply to such dividend.

(5) *Certain dividends from a DISC or former DISC*—(i) *General rule.* A dividend described in this subparagraph is a dividend from a corporation that is a DISC or former DISC (as defined in section 992(a)) other than a dividend that—

(*a*) Is deemed paid by a DISC, for taxable years beginning before January 1, 1976, under section 995(b)(1)(D) as in effect for taxable years beginning before January 1, 1976, and for taxable years beginning after December 31, 1975, under section 995(b)(1) (D), (E), and (F) to the extent provided in subdivision (iii) of this subparagraph or

(*b*) Reduces under §1.996–3(b)(3) accumulated DISC income (as defined in subdivision (ii)(*b*) of this subparagraph) to the extend provided in subdivision (iv) of this subparagraph.

Thus, a dividend deemed paid under section 995(b)(1) (A), (B), or (C) (relating to certain deemed distributions in qualified years) will be treated in full as gross income from sources within the United States. To the extent that a dividend from a DISC or former DISC is paid out of other earnings and profits (as defined in §1.996–3(d)), subparagraph (2) of this paragraph shall apply. To the extent that a dividend from a DISC or former DISC is paid out of previously taxed income (as defined in §1.996–3(c)), see section 996(a)(3) (relating to the exclusion from gross income of amounts distributed out of previously taxed income). In determining the source of income of certain dividends from a DISC or former DISC, the source of income from any transaction which gives rise to gross receipts (as defined in §1.993–6), in the hands of the DISC or former DISC, is immaterial.

(ii) *Definitions.* For purposes of this subparagraph, the term—

(*a*) ''Dividend from'' means any amount actually distributed which is a dividend within the meaning of section 316 (including distributions to meet

qualification requirements under section 992(c)) and any amount treated as a distribution taxable as a dividend pursuant to section 995(b) (relating to deemed distributions in qualified years or upon disqualification) or included in gross income as a dividend pursuant to section 995(c) (relating to gain on certain dispositions of stock in a DISC or former DISC), and

(*b*) ''Accumulated DISC income'' means the amount of accumulated DISC income as of the close of the taxable year immediately preceding the taxable year in which the dividend was made increased by the amount of DISC income for the taxable year in which the dividend was made (as determined under § 1.996–3(b)(2)).

(*c*) ''Nonqualified export taxable income'' means the taxable income of a DISC from any transaction which gives rise to gross receipts (as defined in § 1.993–6) which are not qualified export receipts (as defined in § 1.993–1) other than a transaction giving rise to gain described in section 995(b)(1) (B) or (C).

For purposes of subdivisions (i)(*b*) and (iv) of this subparagraph, if by reason of section 995(c), gain is included in the shareholder's gross income as a dividend, accumulated DISC income shall be treated as if it were reduced under § 1.996–3(b)(3).

(iii) *Determination of source of income for deemed distributions, for taxable years beginning before January 1, 1976, under section 995(b)(1)(D) as in effect for taxable years beginning before January 1, 1976, and for taxable years beginning after December 31, 1975, under section 995(b)(1)(D), (E), and (F).* (*a*) If for its taxable year a DISC does not have any nonqualified export taxable income, then for such year the entire amount treated, for taxable years beginning before January 1, 1976, under section 995(b)(1)(D) as in effect for taxable years beginning before January 1, 1976, and for taxable years beginning after December 31, 1975, under section 995(b)(1) (D), (E), and (F) as a deemed distribution taxable as a dividend will be treated as gross income from sources without the United States.

(*b*) If for its taxable year a DISC has any nonqualified export taxable income, then for such year the portion of the amount treated, for taxable years beginning before January 1, 1976, under section 995(b)(1)(D) as in effect for taxable years beginning before January 1, 1976, and for taxable years beginning after December 31, 1975, under section 995(b)(1) (D), (E), and (F) as a deemed distribution taxable as a dividend that will be treated as income from sources within the United States shall be equal to the amount of such nonqualified export taxable income multiplied by the following fraction. The numerator of the fraction is the sum of the amounts treated, for taxable years beginning before January 1, 1976, under section 995(b)(1)(D) as in effect for taxable years beginning before January 1, 1976, and for taxable years beginning after December 31, 1975, under section 995(b)(1) (D), (E), and (F) as deemed distributions taxable as dividends. The denominator of the fraction is the taxable income of the DISC for the taxable year, reduced by the amounts treated under section 995(b)(1) (A), (B), and (C) as deemed distributions taxable as dividends. However, in no event shall the numerator exceed the denominator. The remainder of such dividend will be treated as gross income from sources without the United States.

(iv) *Determination of source of income for dividends that reduce accumulated DISC income.* (*a*) If no portion of the accumulated DISC income of a DISC or former DISC is attributable to nonqualified export taxable income from any transaction during a year for which it is (or is treated as) a DISC, then the entire amount of any dividend that reduces under § 1.996–3(b)(3) accumulated DISC income will be treated as income from sources without the United States.

(*b*) If any portion of the accumulated DISC income of a DISC or former DISC is attributable to nonqualified export taxable income from any transaction during a year for which it is (or is treated as) a DISC, then the portion of any dividend during its taxable year that reduces under § 1.996–3(b)(3) accumulated DISC income that will be treated as income from sources within the United States shall be equal to the amount of such dividend multiplied by a fraction (determined as of the close of such year) the numerator of which is

the amount of accumulated DISC income attributable to nonqualified export taxable income, and the denominator of which is the total amount of accumulated DISC income. The remainder of such dividend will be treated as gross income from sources without the United States.

(v) *Special rules*. For purposes of subdivisions (iii) and (iv) of this subparagraph—

(*a*) Taxable income shall be determined under §1.992–3(b)(2)(i) (relating to the computation of deficiency distribution), and

(*b*) The portion of any deemed distribution taxable as a dividend, for taxable years beginning before January 1, 1976, under section 995(b)(1)(D) as in effect for taxable years beginning before January 1, 1976, and for taxable years beginning after December 31, 1975, under section 995(b)(1)(D), (E), and (F) or amount under §1.996–3(b)(3) (i) through (iv) that is treated as gross income from sources within the United States during the taxable year shall be considered to reduce the amount of nonqualified export taxable income as of the close of such year.

(vi) *Illustrations*. This subparagraph may be illustrated by the following examples:

Example 1. (a) Y is a corporation which uses the calendar year as its taxable year and which elects to be treated as a DISC beginning with 1972. X is its sole shareholder. In 1973, Y has $18,000 of taxable income from qualified export receipts (none of which are interest and gains described in section 995(b)(1)(A), (B), and (C)) and $1,000 of nonqualified export taxable income. Under these facts, X is deemed to have received a distribution under section 995(b)(1)(D) as in effect for taxable years beginning before January 1, 1976, of $9,500, *i.e.*, $19,000 X ½. X is treated under subdivision (iii)(*b*) of this subparagraph as having $500, *i.e.*, $1,000 X $9,500/$19,000, from sources within the United States and $9,000 from sources without the United States.

(b) For 1972, assume that Y did not have any nonqualified export taxable income. Pursuant to subdivision (v)(*b*) of this subparagraph, at the beginning of 1974, $500 of Y's accumulated DISC income is attributable to nonqualified export taxable income (iii)(*a*) of this subparagraph), i.e., $1,000—$500.

Example 2. The facts are the same as in example (1) except that in 1973, in addition to the taxable income described in such example, Y has $450 of taxable income from gross interest from producer's loans described in section 995(b)(1)(A). Under these facts, the deemed distribution of $450 under section 995(b)(1)(A) is treated in full under subdivision (i) of this subparagraph as gross income from sources within the United States. The deemed distribution under section 995(b)(1)(D) as in effect for taxable years beginning before January 1, 1976, of $9,500 will be treated in the same manner as in example (1), *i.e.*, $1,000 × $9,500 / ($19,450 − $450).

Example 3. (a) The facts are the same as in example (1) except that in 1973, in addition to the distribution described in such example, Y makes a deemed distribution taxable as a dividend of $100 under section 995(b)(1)(G) (relating to foreign investment attributable to producer's loans) and actual distributions of all of its previously taxed income and of $2,000 taxable as a dividend which reduces accumulated DISC income (as defined in subdivision (ii)(*b*) of this subparagraph). Under §1.996–3(b)(3), accumulated DISC income is first reduced by the deemed distribution of $100 and then by the actual distribution taxable as a dividend of $2,000. As indicated in example (1), for 1972 Y did not have any nonqualified export taxable income. Assume that Y had accumulated DISC income of $12,000 at the end of 1973, $500 of which under example (1) is attributable to nonqualified export taxable income.

(b) The distribution from previously taxed income is excluded from gross income pursuant to section 996(a)(3).

(c) Of the deemed distribution of $100, X is treated under subdivision (iv)(*b*) as having $4.17, i.e., $100 × 500/12,000, from sources within the United States and $95.83, i.e., $100—$4.17, from sources without the United States.

(d) Of the actual distribution taxable as a dividend of $2,000, X is treated under subdivision (iv)(*b*) as having $83.33, i.e., $2,000 × 500/12,000, from sources within the United States and $1,916.67, i.e., $2,000—$83.33, from sources without the United States.

(e) The sum of the amounts deemed and actually distributed as dividends for 1973 that are treated as gross income from sources within the United States is as follows:

	Total dividend	Amount of dividend from sources within the United States
Deemed distribution under sec. 995(b)(1)(D) as in effect for taxable years beginning before January 1, 1976	$9,500	$500.00
Deemed distribution under section 995(b)(1)(G)	100	4.17

	Total dividend	Amount of dividend from sources within the United States
Actual distribution that reduces accumulated DISC income	2,000	83.33
Totals	$11,600	$587.50

Thus, pursuant to subdivision (v)(*b*) of this subparagraph, at the beginning of 1974 Y has $412.50, *i.e.*, $1,000—$587.50, of nonqualified export taxable income.

(f) The result would be the same if Y made an actual distribution taxable as a dividend of $1,500 on March 30, 1973, and another distribution of $500 on December 31, 1973.

Example 4. (a) Z is a corporation which uses the calendar year as its taxable year and which elects to be treated as a DISC beginning with 1972. W is its sole shareholder. At the end of the 1976 Z has previously taxed income of $12,000 and accumulated DISC income of $4,000, $900 of which is attributable to nonqualified export taxable income. In 1977, Z has $20,050 of taxable income from qualified export receipts, of which $550 is from gross income from producer's loans described in section 995(b)(1)(A); Z has $950 of taxable income giving rise to gross receipts which are not qualified export receipts, of which $450 is gain described in section 995(b)(1)(B). Of its total taxable income of $21,000 (which is equal to its earnings and profits for 1977), $1,000 is attributable to sales of military property. Z has an international boycott factor (determined under section 999) of .10, and made an illegal bribe (within the meaning of section 162(c)) of $1,265. The proportion which the amount of Z's adjusted base period export receipts bears to Z's export gross receipts for 1977 is .40 (see section 995(e)(1)). Z makes a deemed distribution taxable as a dividend of $1,000 under section 995(b)(1)(G) (relating to foreign investment attributable to producer's loans) and actual distributions of $32,000.

(b) The deemed distributions of $550 under section 995(b)(1)(A) and $450 under section 995(b)(1)(B) are treated in full under subdivision (i) of this subparagraph as gross income from sources within the United States.

(c) Under these facts, Z has also made the following deemed distributions taxable as dividends to W under the following subdivisions of section 995(b)(1):

(D)	$500,	*i.e.,* ½ × $1,000.
(E)	7,800,	*i.e.*,.40 × [$21,000 − $(550 + 450 + 500)].
(F)(i)	5,850,	*i.e.,* ½ × [$21,000 − $550 + 450 + 500 + 7,800)].
(ii)	585,	*i.e.,* $5,850 × .10
(iii)	1,265	
Total	16,000	

(d) The portion of the total amount of these deemed distributions ($16,000 that is treated under the subdivision (iii)(*b*) as gross income from sources within the United States is computed as follows:

(1) The amount of nonqualified export taxable income is $500, i.e., taxable income giving rise to gross receipts which are not qualified export receipts ($950) minus gain described in section 995(b)(1) (B) or (C) ($450).

(2) $500 × ($16,000/$[21,000 − (550 + 450)]) = $400.

The remainder of these distributions, $15,600 ($16,000 minus $400), is treated under subdivision (iii)(*b*) of this subparagraph as gross income from sources without the United States.

(e) The earnings and profits accounts of Z at the end of 1977 are computed as follows:

	Total earnings and profits	Previously taxed income	Accumulated DISC income attributable to taxable income from translations which give rise to gross receipts which—	
			Are qualified export receipts	Are not qualified export receipts
(1) Balance: January 1, 1977	$16,000	$12,000	$3,100	$900
(2) Earnings and profits for 1977, before actual and section 955(b)(1)(G) distributions	21,000	17,000	3,900	[1] 100
(3) Balance: December 31, 1977	37,000	29,000	7,000	1,000
(4) Distribution under section 995(b)(1)(G)	.....	1,000	(875)	[2] (125)
(5) Balance	37,000	30,000	6,125	875
(6) Actual distribution	(32,000)	(30,000)	(1,750)	[3] (250)
(7) Balance: January 1, 1978	5,000	.....	4,375	625

[1] The total of nonqualified export taxable income ($500) minus the portion of such income, under subdivision (iii)(*b*) of this subparagraph, deemed distributed pursuant to section 995(b)(1)(D), (E), and (F) ($400), as computed under (d)(2) of this example.

[2] Under subdivision (iv)(*b*) of this subparagraph, $1,000/$8,000 × $1,000.

[3] Under subdivision (iv)(*b*) of this subparagraph, $1,000/$8,000 × $2,000 (amount of actual distribution that reduces accumulated DISC income).

(6) *Substitute dividend payments.* A substitute dividend payment is a payment, made to the transferor of a security in a securities lending transaction or a sale-repurchase transaction, of an amount equivalent to a dividend distribution which the owner of the transferred security is entitled to receive during the term of the transaction. A securities lending transaction is a transfer of one or more securities that is described in section 1058(a) or a substantially similar transaction. A sale-repurchase transaction is an agreement under which a person transfers a security in exchange for cash and simultaneously agrees to receive substantially identical securities from the transferee in the future in exchange for cash. A substitute dividend payment shall be sourced in the same manner as the distributions with respect to the transferred security for purposes of this section and §1.862–1. See also §§1.864–5(b)(2)(iii), 1.871–7(b)(2) and 1.881–2(b)(2) for the character of such payments and §1.894–1(c) for the application of tax treaties to these transactions.

(b) *Special rules*—(1) *Foreign corporation having no gross income for period preceding declaration of dividend.* If the foreign corporation has no gross income from any source for the 3-year period (or part thereof) specified in paragraph (a)(3)(i) of this section, the 50-percent test, or the apportionment formula, as the case may be, described in such paragraph shall be applied solely with respect to the taxable year of such corporation in which the declaration of the dividend occurs. This subparagraph applies whether the lack of gross income for the 3-year period (or part thereof) stems from the business inactivity of the foreign corporation, from the fact that such corporation is newly created or organized, or from any other cause.

(2) *Transitional rule.* For purposes of applying paragraph (a)(3)(i) of this section, the gross income of the foreign corporation for any period before the first taxable year beginning after December 31, 1966, which is from sources within the United States (determined as provided by sections 861 through 863, and the regulations thereunder, as in effect immediately before amendment by section 102 of the Foreign Investors Tax Act of 1966 (Pub. L. 89–809, 80 Stat. 1541)) shall be treated as gross income for such period which is effectively connected with the conduct of a trade or business within the United States by such foreign corporation.

(3) *Gross income determinations.* In making determinations under subparagraph (2) or (3) of paragraph (a) of this section, or subparagraph (2) of this paragraph—

(i) The gross income of a domestic corporation is to be determined by excluding any items specifically excluded from gross income under chapter 1 of the Code.

(ii) The gross income of a foreign corporation which is effectively connected with the conduct of a trade or business in the United States is to be determined under section 882(b)(2) and by excluding any items specifically excluded from gross income under chapter 1 of the Code, and

(iii) The gross income from all sources of a foreign corporation is to be determined without regard to section 882(b) and without excluding any items otherwise specifically excluded from gross income under chapter 1 of the Code.

(c) *Statement with return.* Any taxpayer who is required to file a return and applies any provision of this section to exclude any dividend from his gross income must file with his return a statement setting forth the amount so excluded, the date of its receipt, the name and address of the corporation paying the dividend, and, if known, the location of the records which substantiate the amount of the exclusion. A statement from the paying corporation setting forth such information and indicating the amount of the dividend to be treated as income from sources within the United States may be used for this purpose. See §§1.6012–1(b)(1)(i) and 1.6012–2 (g)(1)(i).

(d) *Effective/applicability date.* Except as otherwise provided in this paragraph this section applies with respect to dividends received or accrued after December 31, 1966. Paragraph (a)(5) of this section applies to certain dividends from a DISC or former DISC in taxable years ending after December 31, 1971.

Paragraph (a)(6) of this section is applicable to payments made after November 13, 1997. For purposes of paragraph (a)(5) of this section, any reference to a distribution taxable as a dividend under section 995(b)(1)(F) (ii) and (iii) for taxable years beginning after December 31, 1975, shall also constitute a reference to any distribution taxable as a dividend under section 995(b)(1)(F) (ii) and (iii) for taxable years beginning after November 30, 1975, but before January 1, 1976. For corresponding rules applicable with respect to dividends received or accrued before January 1, 1967, see 26 CFR 1.861–3 (Revised as of January 1, 1972). Paragraph (a)(2) of this section applies to taxable years ending after April 9, 2008.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960]

EDITORIAL NOTE: For FEDERAL REGISTER citations affecting § 1.861–3, see the List of CFR Sections Affected, which appears in the Finding Aids section of the printed volume and at *www.fdsys.gov*.

§ 1.861–4 Compensation for labor or personal services.

(a) *Compensation for labor or personal services performed wholly within the United States.* (1) Generally, compensation for labor or personal services, including fees, commissions, fringe benefits, and similar items, performed wholly within the United States is gross income from sources within the United States.

(i) The labor or services are performed by a nonresident alien individual temporarily present in the United States for a period or periods not exceeding a total of 90 days during his taxable year,

(ii) The compensation for such labor or services does not exceed in the aggregate a gross amount of $3,000, and

(iii) The compensation is for labor or services performed as an employee of, or under any form of contract with—

(*a*) A nonresident alien individual, foreign partnership, or foreign corporation, not engaged in trade or business within the United States, or

(*b*) An individual who is a citizen or resident of the United States, a domestic partnership, or a domestic corporation, if such labor or services are performed for an office or place of business maintained in a foreign country or in a possession of the United States by such individual, partnership, or corporation.

(2) As a general rule, the term ''day'', as used in subparagraph (1)(i) of this paragraph, means a calendar day during any portion of which the nonresident alien individual is physically present in the United States.

(3) Solely for purposes of applying this paragraph, the nonresident alien individual, foreign partnership, or foreign corporation for which the nonresident alien individual is performing personal services in the United States shall not be considered to be engaged in trade or business in the United States by reason of the performance of such services by such individual.

(4) In determining for purposes of subparagraph (1)(ii) of this paragraph whether compensation received by the nonresident alien individual exceeds in the aggregate a gross amount of $3,000, any amounts received by the individual from an employer as advances or reimbursements for travel expenses incurred on behalf of the employer shall be omitted from the compensation received by the individual, to the extent of expenses incurred, where he was required to account and did account to his employer for such expenses and has met the tests for such accounting provided in § 1.162–17 and paragraph (e)(4) of § 1.274–5. If advances or reimbursements exceed such expenses, the amount of the excess shall be included as compensation for personal services for purposes of such subparagraph. Pensions and retirement pay attributable to labor or personal services performed in the United States are not to be taken into account for purposes of subparagraph (1)(ii) of this paragraph. (5) For definition of the term ''United States'', when used in a geographical sense, see sections 638 and 7701(a)(9).

(b) *Compensation for labor or personal services performed partly within and partly without the United States*—(1) *Compensation for labor or personal services performed by persons other than individuals*—(i) *In general.* In the case of compensation for labor or personal services performed partly within and partly without the United States by a person other than an individual, the part of

that compensation that is attributable to the labor or personal services performed within the United States, and that is therefore included in gross income as income from sources within the United States, is determined on the basis that most correctly reflects the proper source of the income under the facts and circumstances of the particular case. In many cases, the facts and circumstances will be such that an apportionment on the time basis, as defined in paragraph (b)(2)(ii)(E) of this section, will be acceptable.

(ii) *Example.* The application of paragraph (b)(1)(i) is illustrated by the following example.

Example. Corp X, a domestic corporation, receives compensation of $150,000 under a contract for services to be performed concurrently in the United States and in several foreign countries by numerous Corp X employees. Each Corp X employee performing services under this contract performs his or her services exclusively in one jurisdiction. Although the number of employees (and hours spent by employees) performing services under the contract within the United States equals the number of employees (and hours spent by employees) performing services under the contract without the United States, the compensation paid to employees performing services under the contract within the United States is higher because of the more sophisticated nature of the services performed by the employees within the United States. Accordingly, the payroll cost for employees performing services under the contract within the United States is $20,000 out of a total contract payroll cost of $30,000. Under these facts and circumstances, a determination based upon relative payroll costs would be the basis that most correctly reflects the proper source of the income received under the contract. Thus, of the $150,000 of compensation included in Corp X's gross income, $100,000 ($150,000 × $20,000/$30,000) is attributable to the labor or personal services performed within the United States and $50,000 ($150,000 × $10,000/$30,000) is attributable to the labor or personal services performed without the United States.

(2) *Compensation for labor or personal services performed by an individual*—(i) *In general.* Except as provided in paragraph (b)(2)(ii) of this section, in the case of compensation for labor or personal services performed partly within and partly without the United States by an individual, the part of such compensation that is attributable to the labor or personal services performed within the United States, and that is therefore included in gross income as income from sources within the United States, is determined on the basis that most correctly reflects the proper source of that income under the facts and circumstances of the particular case. In many cases, the facts and circumstances will be such that an apportionment on a time basis, as defined in paragraph (b)(2)(ii)(E) of this section, will be acceptable.

(ii) *Employee compensation*—(A) *In general.* Except as provided in paragraph (b)(2)(ii)(B) or (C) of this section, in the case of compensation for labor or personal services performed partly within and partly without the United States by an individual as an employee, the part of such compensation that is attributable to the labor or personal services performed within the United States, and that is therefore included in gross income as income from sources within the United States, is determined on a time basis, as defined in paragraph (b)(2)(ii)(E) of this section.

(B) *Certain fringe benefits sourced on a geographical basis.* Except as provided in paragraph (b)(2)(ii)(C) of this section, items of compensation of an individual as an employee for labor or personal services performed partly within and partly without the United States that are described in paragraphs (b)(2)(ii)(D)(*1*) through (*6*) of this section are sourced on a geographical basis in accordance with those paragraphs.

(C) *Exceptions and special rules*—(*1*) *Alternative basis*—(*i*) *Individual as an employee generally.* An individual may determine the source of his or her compensation as an employee for labor or personal services performed partly within and partly without the United States under an alternative basis if the individual establishes to the satisfaction of the Commissioner that, under the facts and circumstances of the particular case, the alternative basis more properly determines the source of the compensation than a basis described in paragraph (b)(2)(ii)(A) or (B), whichever is applicable, of this section. An individual that uses an alternative basis must retain in his or her records documentation setting forth why the alternative basis more properly determines

the source of the compensation. In addition, the individual must provide the information related to the alternative basis required by applicable Federal tax forms and accompanying instructions.

(*ii*) *Determination by Commissioner*. The Commissioner may, under the facts and circumstances of the particular case, determine the source of compensation that is received by an individual as an employee for labor or personal services performed partly within and partly without the United States under an alternative basis other than a basis described in paragraph (b)(2)(ii)(A) or (B) of this section if such compensation either is not for a specific time period or constitutes in substance a fringe benefit described in paragraph (b)(2)(ii)(D) of this section notwithstanding a failure to meet any requirement of paragraph (b)(2)(ii)(D) of this section. The Commissioner may make this determination only if such alternative basis determines the source of compensation in a more reasonable manner than the basis used by the individual pursuant to paragraph (b)(2)(ii)(A) or (B) of this section.

(*2*) *Ruling or other administrative pronouncement with respect to groups of taxpayers*. The Commissioner may, by ruling or other administrative pronouncement applying to similarly situated taxpayers generally, permit individuals to determine the source of their compensation as an employee for labor or personal services performed partly within and partly without the United States under an alternative basis. Any such individual shall be treated as having met the requirement to establish such alternative basis to the satisfaction of the Commissioner under the facts and circumstances of the particular case, provided that the individual meets the other requirements of paragraph (b)(2)(ii)(C)(*1*)(*i*) of this section. The Commissioner also may, by ruling or other administrative pronouncement, indicate the circumstances in which he will require individuals to determine the source of certain compensation as an employee for labor or personal services performed partly within and partly without the United States under an alternative basis pursuant to the authority under paragraph (b)(2)(ii)(C)(*1*)(*ii*) of this section.

(*3*) *Artists and athletes*. [Reserved]

(D) *Fringe benefits sourced on a geographical basis*. Except as provided in paragraph (b)(2)(ii)(C) of this section, compensation of an individual as an employee for labor or personal services performed partly within and partly without the United States in the form of the following fringe benefits is sourced on a geographical basis as indicated in this paragraph (b)(2)(ii)(D). The amount of the compensation in the form of the fringe benefit must be reasonable, and the individual must substantiate such amounts by adequate records or by sufficient evidence under rules similar to those set forth in §1.274–5T(c) or (h) or §1.132–5. For purposes of this paragraph (b)(2)(ii)(D), the term *principal place of work* has the same meaning that it has for purposes of section 217 and §1.217–2(c)(3).

(*1*) *Housing fringe benefit*. The source of compensation in the form of a housing fringe benefit is determined based on the location of the individual's principal place of work. For purposes of this paragraph (b)(2)(ii)(D)(*1*), a housing fringe benefit includes payments to or on behalf of an individual (and the individual's family if the family resides with the individual) only for rent, utilities (other than telephone charges), real and personal property insurance, occupancy taxes not deductible under section 164 or 216(a), nonrefundable fees paid for securing a leasehold, rental of furniture and accessories, household repairs, residential parking, and the fair rental value of housing provided in kind by the individual's employer. A housing fringe benefit does not include payments for expenses or items set forth in §1.911–4(b)(2).

(*2*) *Education fringe benefit*. The source of compensation in the form of an education fringe benefit for the education expenses of the individual's dependents is determined based on the location of the individual's principal place of work. For purposes of this paragraph (b)(2)(ii)(D)(*2*), an education fringe benefit includes payments only for qualified tuition and expenses of the type described in section 530(b)(4)(A)(i) (regardless of whether incurred in connection with enrollment

or attendance at a school) and expenditures for room and board and uniforms as described in section 530(b)(4)(A)(ii) with respect to education at an elementary or secondary educational institution.

(*3*) *Local transportation fringe benefit.* The source of compensation in the form of a local transportation fringe benefit is determined based on the location of the individual's principal place of work. For purposes of this paragraph (b)(2)(ii)(D)(*3*), an individual's local transportation fringe benefit is the amount that the individual receives as compensation for local transportation of the individual or the individual's spouse or dependents at the location of the individual's principal place of work. The amount treated as a local transportation fringe benefit is limited to the actual expenses incurred for local transportation and the fair rental value of any vehicle provided by the employer and used predominantly by the individual or the individual's spouse or dependents for local transportation. For this purpose, actual expenses incurred for local transportation do not include the cost (including interest) of the purchase by the individual, or on behalf of the individual, of an automobile or other vehicle.

(*4*) *Tax reimbursement fringe benefit.* The source of compensation in the form of a foreign tax reimbursement fringe benefit is determined based on the location of the jurisdiction that imposed the tax for which the individual is reimbursed.

(*5*) *Hazardous or hardship duty pay fringe benefit.* The source of compensation in the form of a hazardous or hardship duty pay fringe benefit is determined based on the location of the hazardous or hardship duty zone for which the hazardous or hardship duty pay fringe benefit is paid. For purposes of this paragraph (b)(2)(ii)(D)(*5*), a hazardous or hardship duty zone is any place in a foreign country which is either designated by the Secretary of State as a place where living conditions are extraordinarily difficult, notably unhealthy, or where excessive physical hardships exist, and for which a post differential of 15 percent or more would be provided under section 5925(b) of title 5 of the U.S. Code to any officer or employee of the U.S. Government present at that place, or where a civil insurrection, civil war, terrorism, or wartime conditions threatens physical harm or imminent danger to the health and well-being of the individual. Compensation provided an employee during the period that the employee performs labor or personal services in a hazardous or hardship duty zone may be treated as a hazardous or hardship duty pay fringe benefit only if the employer provides the hazardous or hardship duty pay fringe benefit only to employees performing labor or personal services in a hazardous or hardship duty zone. The amount of compensation treated as a hazardous or hardship duty pay fringe benefit may not exceed the maximum amount that the U.S. government would allow its officers or employees present at that location.

(*6*) *Moving expense reimbursement fringe benefit.* Except as otherwise provided in this paragraph (b)(2)(ii)(D)(*6*), the source of compensation in the form of a moving expense reimbursement is determined based on the location of the employee's new principal place of work. The source of such compensation is determined based on the location of the employee's former principal place of work, however, if the individual provides sufficient evidence that such determination of source is more appropriate under the facts and circumstances of the particular case. For purposes of this paragraph (b)(2)(ii)(D)(*6*), sufficient evidence generally requires an agreement, between the employer and the employee, or a written statement of company policy, which is reduced to writing before the move and which is entered into or established to induce the employee or employees to move to another country. Such written statement or agreement must state that the employer will reimburse the employee for moving expenses that the employee incurs to return to the employee's former principal place of work regardless of whether he or she continues to work for the employer after returning to that location. The writing may contain certain conditions upon which the right to reimbursement is determined as long as those conditions set forth standards

that are definitely ascertainable and can only be fulfilled prior to, or through completion of, the employee's return move to the employee's former principal place of work.

(E) *Time basis*. The amount of compensation for labor or personal services performed within the United States determined on a time basis is the amount that bears the same relation to the individual's total compensation as the number of days of performance of the labor or personal services by the individual within the United States bears to his or her total number of days of performance of labor or personal services. A unit of time less than a day may be appropriate for purposes of this calculation. The time period for which the compensation for labor or personal services is made is presumed to be the calendar year in which the labor or personal services are performed, unless the taxpayer establishes to the satisfaction of the Commissioner, or the Commissioner determines, that another distinct, separate, and continuous period of time is more appropriate. For example, a transfer during a year from a position in the United States to a foreign posting that lasted through the end of that year would generally establish two separate time periods within that taxable year. The first of these time periods would be the portion of the year preceding the start of the foreign posting, and the second of these time periods would be the portion of the year following the start of the foreign posting. However, in the case of a foreign posting that requires short-term returns to the United States to perform services for the employer, such short-term returns would not be sufficient to establish distinct, separate, and continuous time periods within the foreign posting time period but would be relevant to the allocation of compensation relating to the overall time period. In each case, the source of the compensation on a time basis is based upon the number of days (or unit of time less than a day, if appropriate) in that separate time period.

(F) *Multi-year compensation arrangements*. The source of multi-year compensation is determined generally on a time basis, as defined in paragraph (b)(2)(ii)(E) of this section, over the period to which such compensation is attributable. For purposes of this paragraph (b)(2)(ii)(F), *multi-year compensation* means compensation that is included in the income of an individual in one taxable year but that is attributable to a period that includes two or more taxable years. The determination of the period to which such compensation is attributable, for purposes of determining its source, is based upon the facts and circumstances of the particular case. For example, an amount of compensation that specifically relates to a period of time that includes several calendar years is attributable to the entirety of that multi-year period. The amount of such compensation that is treated as from sources within the United States is the amount that bears the same relationship to the total multi-year compensation as the number of days (or unit of time less than a day, if appropriate) that labor or personal services were performed within the United States in connection with the project bears to the total number of days (or unit of time less than a day, if appropriate) that labor or personal services were performed in connection with the project. In the case of stock options, the facts and circumstances generally will be such that the applicable period to which the compensation is attributable is the period between the grant of an option and the date on which all employment-related conditions for its exercise have been satisfied (the vesting of the option).

(G) *Examples*. The following examples illustrate the application of this paragraph (b)(2)(ii):

Example 1. B, a nonresident alien individual, was employed by Corp M, a domestic corporation, from March 1 to December 25 of the taxable year, a total of 300 days, for which B received compensation in the amount of $80,000. Under B's employment contract with Corp M, B was subject to call at all times by Corp M and was in a payment status on a 7-day week basis. Pursuant to that contract, B performed services (or was available to perform services) within the United States for 180 days and performed services (or was available to perform services) without the United States for 120 days. None of B's $80,000 compensation was for fringe benefits as identified in paragraph (b)(2)(ii)(D) of this section. B determined the amount of compensation that is attributable to his labor or personal services performed

within the United States on a time basis under paragraph (b)(2)(ii)(A) and (E) of this section. B did not assert, pursuant to paragraph (b)(2)(ii)(C)(*1*)(*i*) of this section, that, under the particular facts and circumstances, an alternative basis more properly determines the source of that compensation than the time basis. Therefore, B must include in income from sources within the United States $48,000 ($80,000 × 180/300) of his compensation from Corporation M.

Example 2. (i) Same facts as in *Example 1* except that Corp M had a company-wide arrangement with its employees, including B, that they would receive an education fringe benefit, as described in paragraph (b)(2)(ii)(D)(*2*) of this section, while working in the United States. During the taxable year, B incurred education expenses for his dependent daughter that qualified for the education fringe benefit in the amount of $10,000, for which B received a reimbursement from Corp M. B did not maintain adequate records or sufficient evidence of this fringe benefit as required by paragraph (b)(2)(ii)(D) of this section. When B filed his Federal income tax return for the taxable year, B did not apply paragraphs (b)(2)(ii)(B) and (D)(*2*) of this section to treat the compensation in the form of the education fringe benefit as income from sources within the United States, the location of his principal place of work during the 300-day period. Rather, B combined the $10,000 reimbursement with his base compensation of $80,000 and applied the time basis of paragraph (b)(2)(ii)(A) of this section to determine the source of his gross income.

(ii) On audit, B argues that because he failed to substantiate the education fringe benefit in accordance with paragraph (b)(2)(ii)(D) of this section, his entire employment compensation from Corp M is sourced on a time basis pursuant to paragraph (b)(2)(ii)(A) of this section. The Commissioner, after reviewing Corp M's fringe benefit arrangement, determines, pursuant to paragraph (b)(2)(ii)(C)(*1*)(*ii*) of this section, that the $10,000 educational expense reimbursement constitutes in substance a fringe benefit described in paragraph (b)(2)(ii)(D)(*2*) of this section, notwithstanding a failure to meet all of the requirements of paragraph (b)(2)(ii)(D) of this section, and that an alternative geographic source basis, under the facts and circumstances of this particular case, is a more reasonable manner to determine the source of the compensation than the time basis used by B.

Example 3. (i) A, a United States citizen, is employed by Corp N, a domestic corporation. A's principal place of work is in the United States. A earns an annual salary of $100,000. During the first quarter of the calendar year (which is also A's taxable year), A performed services entirely within the United States. At the beginning of the second quarter of the calendar year, A was transferred to Country X for the remainder of the year and received, in addition to her annual salary, $30,000 in fringe benefits that are attributable to her new principal place of work in Country X. Corp N paid these fringe benefits separately from A's annual salary. Corp N supplied A with a statement detailing that $25,000 of the fringe benefit was paid for housing, as defined in paragraph (b)(2)(ii)(D)(*1*) of this section, and $5,000 of the fringe benefit was paid for local transportation, as defined in paragraph (b)(2)(ii)(D)(*3*) of this section. None of the local transportation fringe benefit is excluded from the employee's gross income as a qualified transportation fringe benefit under section 132(a)(5). Under A's employment contract, A was required to work on a 5-day week basis, Monday through Friday. During the last three quarters of the year, A performed services 30 days in the United States and 150 days in Country X and other foreign countries.

(ii) A determined the source of all of her compensation from Corp N pursuant to paragraphs (b)(2)(ii)(A), (B), and (D)(*1*) and (*3*) of this section. A did not assert, pursuant to paragraph (b)(2)(ii)(C)(*1*)(i) of this section, that, under the particular facts and circumstances, an alternative basis more properly determines the source of that compensation than the bases set forth in paragraphs (b)(2)(ii)(A), (B), and (D)(*1*) and (*3*) of this section. However, in applying the time basis set forth in paragraph (b)(2)(ii)(E) of this section, A establishes to the satisfaction of the Commissioner that the first quarter of the calendar year and the last three quarters of the calendar year are two separate, distinct, and continuous periods of time. Accordingly, $25,000 of A's annual salary is attributable to the first quarter of the year (25 percent of $100,000). This amount is entirely compensation that was attributable to the labor or personal services performed within the United States and is, therefore, included in gross income as income from sources within the United States. The balance of A's compensation as an employee of Corp N, $105,000 (which includes the $30,000 in fringe benefits that are attributable to the location of A's principal place of work in Country X), is compensation attributable to the final three quarters of her taxable year. During those three quarters, A's periodic performance of services in the United States does not result in distinct, separate, and continuous periods of time. Of the $75,000 paid for annual salary, $12,500 (30/180 × $75,000) is compensation that was attributable to the labor or personal services performed within the United States and $62,500 (150/180 × $75,000) is compensation that was attributable to the labor or personal services performed outside the United States. Pursuant to paragraphs (b)(2)(ii)(B) and (D)(*1*) and (*3*) of this section, A sourced the $25,000 received for the housing fringe

benefit and the $5,000 received for the local transportation fringe benefit based on the location of her principal place of work, Country X. Accordingly, A included the $30,000 in fringe benefits in her gross income as income from sources without the United States.

Example 4. Same facts as in *Example 3*. Of the 150 days during which A performed services in Country X and in other foreign countries (during the final three quarters of A's taxable year), she performed 30 days of those services in Country Y. Country Y is a country designated by the Secretary of State as a place where living conditions are extremely difficult, notably unhealthy, or where excessive physical hardships exist and for which a post differential of 15 percent or more would be provided under section 5925(b) of title 5 of the U.S. Code to any officer or employee of the U.S. government present at that place. Corp N has a policy of paying its employees a $65 premium per day for each day worked in countries so designated. The $65 premium per day does not exceed the maximum amount that the U. S. government would pay its officers or employees stationed in Country Y. Because A performed services in Country Y for 30 days, she earned additional compensation of $1,950. The $1,950 is considered a hazardous duty or hardship pay fringe benefit and is sourced under paragraphs (b)(2)(ii)(B) and (D)(*5*) of this section based on the location of the hazardous or hardship duty zone, Country Y. Accordingly, A included the amount of the hazardous duty or hardship pay fringe benefit ($1,950) in her gross income as income from sources without the United States.

Example 5. (i) During 2006 and 2007, Corp P, a domestic corporation, employed four United States citizens, E, F, G, and H to work in its manufacturing plant in Country V. As part of his or her compensation package, each employee arranged for local transportation unrelated to Corp P's business needs. None of the local transportation fringe benefit is excluded from the employee's gross income as a qualified transportation fringe benefit under section 132(a)(5) and (f).

(ii) Under the terms of the compensation package that E negotiated with Corp P, Corp P permitted E to use an automobile owned by Corp P. In addition, Corp P agreed to reimburse E for all expenses incurred by E in maintaining and operating the automobile, including gas and parking. Provided that the local transportation fringe benefit meets the requirements of paragraph (b)(2)(ii)(D)(*3*) of this section, E's compensation with respect to the fair rental value of the automobile and reimbursement for the expenses E incurred is sourced under paragraphs (b)(2)(ii)(B) and (D)(*3*) of this section based on E's principal place of work in Country V. Thus, the local transportation fringe benefit will be included in E's gross income as income from sources without the United States.

(iii) Under the terms of the compensation package that F negotiated with Corp P, Corp P let F use an automobile owned by Corp P. However, Corp P did not agree to reimburse F for any expenses incurred by F in maintaining and operating the automobile. Provided that the local transportation fringe benefit meets the requirements of paragraph (b)(2)(ii)(D)(*3*) of this section, F's compensation with respect to the fair rental value of the automobile is sourced under paragraphs (b)(2)(ii)(B) and (D)(*3*) of this section based on F's principal place of work in Country V. Thus, the local transportation fringe benefit will be included in F's gross income as income from sources without the United States.

(iv) Under the terms of the compensation package that G negotiated with Corp P, Corp P agreed to reimburse G for the purchase price of an automobile that G purchased in Country V. Corp P did not agree to reimburse G for any expenses incurred by G in maintaining and operating the automobile. Because the cost to purchase an automobile is not a local transportation fringe benefit as defined in paragraph (b)(2)(ii)(D)(*3*) of this section, the source of the compensation to G will be determined pursuant to paragraph (b)(2)(ii)(A) or (C) of this section.

(v) Under the terms of the compensation package that H negotiated with Corp P, Corp P agreed to reimburse H for the expenses that H incurred in maintaining and operating an automobile, including gas and parking, which H purchased in Country V. Provided that the local transportation fringe benefit meets the requirements of paragraph (b)(2)(ii)(D)(*3*) of this section, H's compensation with respect to the reimbursement for the expenses H incurred is sourced under paragraphs (b)(2)(ii)(B) and (D)(*3*) of this section based on H's principal place of work in Country V. Thus, the local transportation fringe benefit will be included in H's gross income as income from sources without the United States.

Example 6. (i) On January 1, 2006, Company Q compensates employee J with a grant of options to which section 421 does not apply that do not have a readily ascertainable fair market value when granted. The stock options permit J to purchase 100 shares of Company Q stock for $5 per share. The stock options do not become exercisable unless and until J performs services for Company Q (or a related company) for 5 years. J works for Company Q for the 5 years required by the stock option grant. In years 2006–08, J performs all of his services for Company Q within the United States. In 2009, J performs ½ of his services for Company Q within the United States and ½ of his services for Company Q without the United States. In year 2010, J performs his services entirely without

the United States. On December 31, 2012, J exercises the options when the stock is worth $10 per share. J recognizes $500 in taxable compensation (($10 − $5) × 100) in 2012.

(ii) Under the facts and circumstances, the applicable period is the 5-year period between the date of grant (January 1, 2006) and the date the stock options become exercisable (December 31, 2010). On the date the stock options become exercisable, J performs all services necessary to obtain the compensation from Company Q. Accordingly, the services performed after the date the stock options become exercisable are not taken into account in sourcing the compensation from the stock options. Therefore, pursuant to paragraph (b)(2)(ii)(A), since J performs 3½ years of services for Company Q within the United States and 1½ years of services for Company Q without the United States during the 5-year period, 7/10 of the $500 of compensation (or $350) recognized in 2012 is income from sources within the United States and the remaining 3/10 of the compensation (or $150) is income from sources without the United States.

(c) *Coastwise travel.* Except as to income excluded by paragraph (a) of this section, wages received for services rendered inside the territorial limits of the United States and wages of an alien seaman earned on a coastwise vessel are to be regarded as from sources within the United States.

(d) *Effective date.* This section applies with respect to taxable years beginning after December 31, 1966. For corresponding rules applicable to taxable years beginning before January 1, 1967, see 26 CFR 1.861–4 (Revised as of January 1, 1972). Paragraph (b) and the first sentence of paragraph (a)(1) of this section apply to taxable years beginning on or after July 14, 2005.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 7378, 40 FR 45433, Oct. 2, 1975; 40 FR 48508, Oct. 16, 1975; T.D. 9212, 70 FR 40665, July 14, 2005]

§ 1.861–5 Rentals and royalties.

Gross income from sources within the United States includes rentals or royalties from property located in the United States or from any interest in such property, including rentals or royalties for the use of, or for the privilege of using, in the United States, patents, copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises, and other like property. The income arising from the rental of property, whether tangible or intangible, located within the United States, or from the use of property, whether tangible or intangible, within the United States, is from sources within the United States. For taxable years beginning after December 31, 1966, gains described in section 871(a)(1)(D) and section 881(a)(4) from the sale or exchange after October 4, 1966, of patents, copyrights, and other like property shall be treated, as provided in section 871(e)(2), as rentals or royalties for the use of, or privilege of using, property or an interest in property. See paragraph (e) of § 1.871–11.

[T.D. 7378, 40 FR 45434, Oct. 2, 1975]

§ 1.861–6 Sale of real property.

Gross income from sources within the United States includes gain, computed under the provisions of section 1001 and the regulations thereunder, derived from the sale or other disposition of real property located in the United States. For the treatment of capital gains and losses, see subchapter P (section 1201 and following), chapter 1 of the Code, and the regulations thereunder.

§ 1.861–7 Sale of personal property.

(a) *General.* Gains, profits, and income derived from the purchase and sale of personal property shall be treated as derived entirely from the country in which the property is sold. Thus, gross income from sources within the United States includes gains, profits, and income derived from the purchase of personal property without the United States and its sale within the United States.

(b) *Purchase within a possession.* Notwithstanding paragraph (a) of this section, income derived from the purchase of personal property within a possession of the United States and its sale within the United States shall be treated as derived partly from sources within and partly from sources without the United States. See section 863(b)(3) and § 1.863–2.

(c) *Country in which sold.* For the purposes of part I (section 861 and following), subchapter N, chapter 1 of the Code, and the regulations thereunder, a sale of personal property is consummated at the time when, and the

place where, the rights, title, and interest of the seller in the property are transferred to the buyer. Where bare legal title is retained by the seller, the sale shall be deemed to have occurred at the time and place of passage to the buyer of beneficial ownership and the risk of loss. However, in any case in which the sales transaction is arranged in a particular manner for the primary purpose of tax avoidance, the foregoing rules will not be applied. In such cases, all factors of the transaction, such as negotiations, the execution of the agreement, the location of the property, and the place of payment, will be considered, and the sale will be treated as having been consummated at the place where the substance of the sale occurred.

(d) *Production and sale.* For provisions respecting the source of income derived from the sale of personal property produced by the taxpayer, see section 863(b)(2) and paragraphs (b) of §§ 1.863–1 and 1.863–2.

(e) *Section 306 stock.* For determining the source of gain on the disposition of section 306 stock, see section 306(f) and the regulations thereunder.

§ 1.861–8 Computation of taxable income from sources within the United States and from other sources and activities.

(a) *In general*—(1) *Scope.* Sections 861(b) and 863(a) state in general terms how to determine taxable income of a taxpayer from sources within the United States after gross income from sources within the United States has been determined. Sections 862(b) and 863(a) state in general terms how to determine taxable income of a taxpayer from sources without the United States after gross income from sources without the United States has been determined. This section provides specific guidance for applying the cited Code sections by prescribing rules for the allocation and apportionment of expenses, losses, and other deductions (referred to collectively in this section as ''deductions'') of the taxpayer. The rules contained in this section apply in determining taxable income of the taxpayer from specific sources and activities under other sections of the Code, referred to in this section as operative sections. See paragraph (f)(1) of this section for a list and description of operative sections. The operative sections include, among others, sections 871(b) and 882 (relating to taxable income of a nonresident alien individual or a foreign corporation which is effectively connected with the conduct of a trade or business in the United States), section 904(a)(1) (as in effect before enactment of the Tax Reform Act of 1976, relating to taxable income from sources within specific foreign countries), and section 904(a)(2) (as in effect before enactment of the Tax Reform Act of 1976, or section 904(a) after such enactment, relating to taxable income from all sources without the United States).

(2) *Allocation and apportionment of deductions in general.* A taxpayer to which this section applies is required to allocate deductions to a class of gross income and, then, if necessary to make the determination required by the operative section of the Code, to apportion deductions within the class of gross income between the statutory grouping of gross income (or among the statutory groupings) and the residual grouping of gross income. Except for deductions, if any, which are not definitely related to gross income (see paragraphs (c)(3) and (e)(9) of this section) and which, therefore, are ratably apportioned to all gross income, all deductions of the taxpayer (except the deductions for personal exemptions enumerated in paragraph (e)(11) of this section) must be so allocated and apportioned. As further detailed below, allocations and apportionments are made on the basis of the factual relationship of deductions to gross income.

(3) *Class of gross income.* For purposes of this section, the gross income to which a specific deduction is definitely related is referred to as a ''class of gross income'' and may consist of one or more items (or subdivisions of these items) of gross income enumerated in section 61, namely:

(i) Compensation for services, including fees, commissions, and similar items;

(ii) Gross income derived from business;

(iii) Gains derived from dealings in property;

(iv) Interest;

(v) Rents;

(vi) Royalties;

(vii) Dividends;

(viii) Alimony and separate maintenance payments;

(ix) Annuities;

(x) Income from life insurance and endowment contracts;

(xi) Pensions;

(xii) Income from discharge of indebtedness;

(xiii) Distributive share of partnership gross income;

(xiv) Income in respect of a decedent;

(xv) Income from an interest in an estate or trust.

(4) *Statutory grouping of gross income and residual grouping of gross income.* For purposes of this section, the term ''statutory grouping of gross income'' or ''statutory grouping'' means the gross income from a specific source or activity which must first be determined in order to arrive at ''taxable income'' from which specific source or activity under an operative section. (See paragraph (f)(1) of this section.) Gross income from other sources or activities is referred to as the ''residual grouping of gross income'' or ''residual grouping.'' For example, for purposes of determining taxable income from sources within specific foreign countries and possessions of the United States, in order to apply the per-country limitation to the foreign tax credit (as in effect before enactment of the Tax Reform Act of 1976), the statutory groupings are the separate gross incomes from sources within each country and possession. Moreover, if the taxpayer has income subject to section 904(d) (as in effect after enactment of the Tax Reform Act of 1976), such income constitutes one or more separate statutory groupings. In the case of the per-country limitation, the residual grouping is the aggregate of gross income from sources within the United States. In some instances, where the operative section so requires, the statutory grouping or the residual grouping may include, or consist entirely of, excluded income. See paragraph (d)(2) of this section with respect to the allocation and apportionment of deductions to excluded income.

(5) *Effective date*—(i) *Taxable years beginning after December 31, 1976.* The provisions of this section apply to taxable years beginning after December 31, 1976.

(ii) Paragraph (e)(4), the last sentence of paragraph (f)(4)(i), and paragraph (g), *Examples 17*, *18*, and *30* of this section are generally applicable for taxable years beginning after July 31, 2009. In addition, a person may elect to apply the provisions of paragraph (e)(4) of this section to earlier years. Such election shall be made in accordance with the rules set forth in §1.482–9(n)(2).

(iii) *Taxable years beginning before January 1, 1977.* For taxable years beginning before January 1, 1977, §1.861–8 applies as in effect on October 23, 1957 (T.D. 6258), as amended on August 22, 1966 (T.D. 6892) and on September 29, 1975 (T.D. 7378). The specific rules for allocation and apportionment of deductions set forth in this section may, at the option of the taxpayer, apply to those taxable years on a deduction-by-deduction basis if the rules are applied consistently to all taxable years with respect to which action by the Internal Revenue Service is not barred by any statute of limitations. Thus, for example, a calendar year taxpayer may choose to have the rules of paragraph (e)(2) of this section apply for the allocation and apportionment of all interest expenses for the two taxable years ending December 31, 1975 and 1976, which are open years under examination, and may justify the allocation and apportionment of all research and development expenses for those years on a basis supportable under §1.861–8 as in effect for 1975 and 1976 without regard to the rules of paragraph (e)(3) of this section.

(b) *Allocation*—(1) *In general.* For purposes of this section, the gross income to which a specific deduction is definitely related is referred to as a ''class of gross income'' and may consist of one or more items of gross income. The rules emphasize the factual relationship between the deduction and a class of gross income. See paragraph (d)(1) of this section which provides that in a taxable year there may be no item of gross income in a class or less gross income than deductions allocated to the class, and paragraph (d)(2) of this section which provides that a class of

gross income may include excluded income. Allocation is accomplished by determining, with respect to each deduction, the class of gross income to which the deduction is definitely related and then allocating the deduction to such class of gross income (without regard to the taxpayable year in which such gross income is received or accrued or is expected to be received or accrued). The classes of gross income are not predetermined but must be determined on the basis of the deductions to be allocated. Although most deductions will be definitely related to some class of a taxpayer's total gross income, some deductions are related to all gross income. In addition, some deductions are treated as not definitely related to any gross income and are ratably apportioned to all gross income. (See paragraph (e)(9) of this section.) In allocating deductions it is not necessary to differentiate between deductions related to one item of gross income and deductions related to another item of gross income where both items of gross income are exclusively within the same statutory grouping or exclusively within the residual grouping.

(2) *Relationship to activity or property.* A deduction shall be considered definitely related to a class of gross income and therefore allocable to such class if it is incurred as a result of, or incident to, an activity or in connection with property from which such class of gross income is derived. Where a deduction is incurred as a result of, or incident to, an activity or in connection with property, which activity or property generates, has generated, or could reasonably have been expected to generate gross income, such deduction shall be considered definitely related to such gross income as a class whether or not there is any item of gross income in such class which is received or accrued during the taxable year and whether or not the amount of deductions exceeds the amount of the gross income in such class. See paragraph (d)(1) of this section and example 17 of paragraph (g) of this section with respect to cases in which there is an excess of deductions. In some cases, it will be found that this subparagraph can most readily be applied by determining, with respect to a deduction, the categories of gross income to which it is not related and concluding that it is definitely related to a class consisting of all other gross income.

(3) *Supportive functions.* Deductions which are supportive in nature (such as overhead, general and administrative, and supervisory expenses) may relate to other deductions which can more readily be allocated to gross income. In such instance, such supportive deductions may be allocated and apportioned along with the deductions to which they relate. On the other hand, it would be equally acceptable to attribute supportive deductions on some reasonable basis directly to activities or property which generate, have generated or could reasonably be expected to generate gross income. This would ordinarily be accomplished by allocating the supportive expenses to all gross income or to another broad class of gross income and apportioning the expenses in accordance with paragraph (c)(1) of this section. For this purpose, reasonable departmental overhead rates may be utilized. For examples of the application of the principles of this paragraph (b)(3) to expenses other than expenses attributable to stewardship activities, *see Examples 19* through *21* of paragraph (g) of this section. *See* paragraph (e)(4)(ii) of this section for the allocation and apportionment of deductions attributable to stewardship expenses. However, supportive deductions that are described in §1.861–14T(e)(3) shall be allocated and apportioned in accordance with the rules of §1.861–14T and shall not be allocated and apportioned by reference only to the gross income of a single member of an affiliated group of corporations as defined in §1.861–14T(d).

(4) *Deductions related to a class of gross income.* See paragraph (e) of this section for rules relating to the allocation and apportionment of certain specific deductions definitely related to a class of gross income. See paragraph (c)(1) of this section for rules relating to the apportionment of deductions.

(5) *Deductions related to all gross income.* If a deduction does not bear a definite relationship to a class of gross income constituting less than all of gross income, it shall ordinarily be

treated as definitely related and allocable to all of the taxpayer's gross income except where provided to the contrary under paragraph (e) of this section. Paragraph (e)(9) of this section lists various deductions which generally are not definitely related to any gross income and are ratably apportioned to all gross income.

(c) *Apportionment of deductions*—(1) *Deductions definitely related to a class of gross income*. [Reserved]. For guidance, see §1.861–8T(c)(1).

(2) *Apportionment based on assets*. [Reserved]. For guidance, see §1.861–8T(c)(2).

(3) *Deductions not definitely related to any gross income*. If a deduction is not definitely related to any gross income (see paragraph (e)(9) of this section), the deduction must be apportioned ratably between the statutory grouping (or among the statutory groupings) of gross income and the residual grouping. Thus, the amount apportioned to each statutory grouping shall be equal to the same proportion of the deduction which the amount of gross income in the statutory grouping bears to the total amount of gross income. The amount apportioned to the residual grouping shall be equal to the same proportion of the deduction which the amount of the gross income in the residual grouping bears to the total amount of gross income.

(d) *Excess of deductions and excluded and eliminated income*—(1) *Excess of deductions*. Each deduction which bears a definite relationship to a class of gross income shall be allocated to that class in accordance with paragraph (b)(1) of this section even though, for the taxable year, no gross income in such class is received or accrued or the amount of the deduction exceeds the amount of such class of gross income. In apportioning deductions, it may be that, for the taxable year, there is no gross income in the statutory grouping (or residual grouping), or that deductions exceed the amount of gross income in the statutory grouping (or residual grouping). If there is no gross income in a statutory grouping or the amount of deductions allocated and apportioned to a statutory grouping exceeds the amount of gross income in the statutory grouping, the effects are determined under the operative section. If the taxpayer is a member of a group filing a consolidated return, such excess of deductions allocated or apportioned to a statutory grouping of income of such member is taken into account in determining the consolidated taxable income from such statutory grouping, and such excess of deductions allocated or apportioned to the residual grouping of income is taken into account in determining the consolidated taxable income from the residual grouping. See §1.1502–4(d)(1) and the last sentence of §1.1502–12. For an illustration of the principles of this paragraph (d)(1), see example 17 of paragraph (g) of this section.

(2) *Allocation and apportionment to exempt, excluded, or eliminated income*. [Reserved]. For guidance, see §1.861–8T(d)(2).

(e) *Allocation and apportionment of certain deductions*—(1) *In general*. Paragraphs (e)(2) and (e)(3) of this section contain rules with respect to the allocation and apportionment of interest expense and research and development expenditures, respectively. Paragraphs (e)(4) through (e)(8) of this section contain rules with respect to the allocation of certain other deductions. Paragraph (e)(9) of this section lists those deductions which are ordinarily considered as not being definitely related to any class of gross income. Paragraph (e)(10) of this section lists special deductions of corporations which must be allocated and apportioned. Paragraph (e)(11) of this section lists personal exemptions which are neither allocated nor apportioned. Paragraph (e)(12) of this section contains rules with respect to the allocation and apportionment of deductions for charitable contributions. Examples of allocation and apportionment are contained in paragraph (g) of this section.

(2) *Interest*. [Reserved]. For guidance, see §1.861–8T(e)(2).

(3) *Research and experimental expenditures*. For rules regarding the allocation and apportionment of research and experimental expenditures, see §1.861–17.

(4) *Stewardship and controlled services*—(i) *Expenses attributable to controlled services*. If a corporation performs a controlled services transaction

(as defined in §1.482–9(l)(3)), which includes any activity by one member of a group of controlled taxpayers that results in a benefit to a related corporation, and the rendering corporation charges the related corporation for such services, section 482 and these regulations provide for an allocation where the charge is not consistent with an arm's length result as determined. The deductions for expenses of the corporation attributable to the controlled services transaction are considered definitely related to the amounts so charged and are to be allocated to such amounts.

(ii) *Stewardship expenses attributable to dividends received.* Stewardship expenses, which result from ''overseeing'' functions undertaken for a corporation's own benefit as an investor in a related corporation, shall be considered definitely related and allocable to dividends received, or to be received, from the related corporation. For purposes of this section, stewardship expenses of a corporation are those expenses resulting from ''duplicative activities'' (as defined in §1.482–9(l)(3)(iii)) or ''shareholder activities'' (as defined in §1.482–9(l)(3)(iv)) of the corporation with respect to the related corporation. Thus, for example, stewardship expenses include expenses of an activity the sole effect of which is either to protect the corporation's capital investment in the related corporation or to facilitate compliance by the corporation with reporting, legal, or regulatory requirements applicable specifically to the corporation, or both. If a corporation has a foreign or international department which exercises overseeing functions with respect to related foreign corporations and, in addition, the department performs other functions that generate other foreign-source income (such as fees for services rendered outside of the United States for the benefit of foreign related corporations, foreign-source royalties, and gross income of foreign branches), some part of the deductions with respect to that department are considered definitely related to the other foreign-source income. In some instances, the operations of a foreign or international department will also generate United States source income (such as fees for services performed in the United States). Permissible methods of apportionment with respect to stewardship expenses include comparisons of time spent by employees weighted to take into account differences in compensation, or comparisons of each related corporation's gross receipts, gross income, or unit sales volume, assuming that stewardship activities are not substantially disproportionate to such factors. *See* paragraph (f)(5) of this section for the type of verification that may be required in this respect. *See* §1.482–9(l)(5) for examples that illustrate the principles of §1.482–9(l)(3). *See Example 17* and *Example 18* of paragraph (g) of this section for the allocation and apportionment of stewardship expenses. *See* paragraph (b)(3) of this section for the allocation and apportionment of deductions attributable to supportive functions other than stewardship expenses, such as expenses in the nature of day-to-day management, and paragraph (e)(5) of this section generally for the allocation and apportionment of deductions attributable to legal and accounting fees and expenses.

(5) *Legal and accounting fees and expenses.* Fees and other expenses for legal and accounting services are ordinarily definitely related and allocable to specific classes of gross income or to all the taxpayer's gross income, depending on the nature of the services rendered (and are apportioned as provided in paragraph (c)(1) of this section). For example, accounting fees for the preparation of a study of the costs involved in manufacturing a specific product will ordinarily be definitely related to the class of gross income derived from (or which could reasonably have been expected to be derived from) that specific product. The taxpayer is not relieved from his responsibility to make a proper allocation and apportionment of fees on the grounds that the statement of services rendered does not identify the services performed beyond a generalized designation such as ''professional,'' or does not provide any type of allocation, or does not properly allocate the fees involved.

(6) *Income taxes*—(i) *In general.* The deduction for state, local, and foreign income, war profits and excess profits taxes (''state income taxes'') allowed

by section 164 shall be considered definitely related and allocable to the gross income with respect to which such state income taxes are imposed. For example, if a domestic corporation is subject to state income taxation and the state income tax is imposed in part on an amount of foreign source income, then that part of the taxpayer's deduction for state income tax that is attributable to foreign source income is definitely related and allocable to foreign source income. In allocating and apportioning the deduction for state income tax for purposes including (but not limited to) the computation of the foreign tax credit limitation under section 904 of the Code and the consolidated foreign tax credit under §1.1502–4 of the regulations, the income upon which the state income tax is imposed is determined by reference to the law of the jurisdiction imposing the tax. Thus, if a state attributes taxable income to a corporate taxpayer by applying an apportionment formula that takes into consideration the income and factors of one or more corporations related by ownership to the corporate taxpayer and engaging in activities related to the business of the corporate taxpayer, then the income so attributed is the income upon which the state income tax is imposed. If the income so attributed to the corporate taxpayer includes foreign source income, then, in computing the taxpayer's foreign tax credit limitation under section 904, for example, the taxpayer's deduction for state income tax will be considered definitely related and allocable to a class of gross income that includes the statutory grouping of foreign source income. When the law of the state includes dividends that are treated under section 862(a)(2) as income from sources without the United States in taxable income apportionable to the state, but does not include factors of the corporation paying such dividends in the apportionment formula used to determine state taxable income, an appropriate portion of the deduction for state income tax will be considered definitely related and allocable to a class of gross income consisting solely of foreign source dividend income. A deduction for state income tax will not be considered definitely related to a hypothetical amount of income calculated under federal tax principles when the jurisdiction imposing the tax computes taxable income under different principles. A corporate taxpayer's deduction for a state franchise tax that is computed on the basis of income attributable to business activities conducted within the state must be allocated and apportioned in the same manner as the deduction for state income taxes. In determining, for example, both the foreign tax credit under section 904 of the Code and the consolidated foreign tax credit limitation under §1.1502–4 of the regulations, the deduction for state income tax may be allocable and apportionable to foreign source income in a statutory grouping described in section 904(d) in a taxable year in which the taxpayer has no foreign source income in such statutory grouping. Alternatively, such an allocation or apportionment may be appropriate if a taxpayer corporation has no foreign source income in a statutory grouping, but its deduction is attributable to foreign source income in such grouping that is attributed to the taxpayer corporation under the law of a state which attributes taxable income to a corporation by applying an apportionment formula that takes into consideration the income and factors of one or more corporations related by ownership to the taxpayer corporation and engaging in activities related to the business of the taxpayer corporation. Example 30 of paragraph (g) of this section illustrates the application of this last rule.

(ii) *Methods of allocation and apportionment*—(A) *In general.* A taxpayer's deduction for a state income tax is to be allocated (and then apportioned, if necessary, subject to the rules of §1.861–8(d)) by reference to the taxable income that the law of the taxing jurisdiction attributes to the taxpayer (''state taxable income'').

(B) *Effect of subsequent recomputations of state income tax.* [Reserved]

(C) *Illustrations*—(*1*) *In general.* Examples 25 through 32 of paragraph (g) of §1.861–8 illustrate, in the given factual situations, the application of this paragraph (e)(6) and the general rule of paragraph (b)(1) of this section that a deduction must be allocated to the

class of gross income to which the deduction is factually related. In general, these examples employ a presumption that state income taxes are allocable to a class of gross income that includes the statutory grouping of income from sources without the United States when the total amount of taxable income determined under state law exceeds the amount of taxable income determined under the Code (without taking into account the deduction for state income taxes) in the residual grouping of income from sources within the United States. A taxpayer that allocates and apportions the deduction for state income tax in accordance with the methodology of Example 25 of paragraph (g) of this section must also apply the modifications illustrated in Examples 26 and 27 of paragraph (g) of this section, when applicable. The modification illustrated in *Example 26* is applicable when the deduction for state income tax is attributable in part to taxes imposed by a state which factually excludes foreign source income (as determined for federal income tax purposes) from state taxable income. The modification illustrated in *Example 27* is applicable when the taxpayer has income-producing activities in a state which does not impose a corporate income tax. The specific allocation of state income tax illustrated in Example 28 follows the rule in paragraph (e)(6)(i) of this section, and must be applied whenever a taxpayer's state taxable income includes dividends apportioned to the state under a formula that does not take into account the factors of the corporations paying those dividends, regardless of whether the taxpayer uses the methodology of Example 25 with respect to the remainder of the deduction for state income taxes.

(*2*) *Modifications*. Before applying a method of allocation and apportionment illustrated in the examples, the computation of state taxable income under state law may be modified, subject to the approval of the District Director, to reflect more accurately the income with respect to which the state income tax is imposed. Any modification to the state law computation of state taxable income must yield an allocation and apportionment of the deduction for state income taxes that is consistent with the rules contained in this paragraph (e)(6), and that accurately reflects the factual relationship between the state income tax and the income on which that tax is imposed. For example, a modification to the computation of taxable income under state law might be appropriate to compensate for differences between the state law definition of taxable income and the federal definition of taxable income, due to a difference in the rate of allowable depreciation or the amount of another deduction that is allowable under both systems. This rule is illustrated in Example 31 of paragraph (g) of this section. However, a modification to the computation of taxable income under state law will not be appropriate, and will not more accurately reflect the factual relationship between the state tax and the income on which the tax is imposed, to the extent such modification reflects the fact that the state does not follow federal tax principles in attributing income to the taxpayer's activities in the state. This rule is illustrated in Example 32 of paragraph (g) of this section. A taxpayer may not modify the methods illustrated in the examples, or use an alternative method of allocation and apportionment of the deduction for state income taxes, if the modification or alternative method would be inconsistent with the rules of paragraph (e)(6)(i) of this section. A taxpayer that uses a method of allocation and apportionment other than one illustrated in Example 25 (as modified by Examples 26 and 27), or 29 with respect to a factual situation similar to those of the examples, must describe the alternative method on an attachment to its federal income tax return and establish to the satisfaction of the District Director, upon examination, that the result of the alternative method more accurately reflects the factual relationship between the state income tax and the income on which the tax is imposed.

(D) *Elective safe harbor methods*—(*1*) *In general*. In lieu of applying the rules set forth in paragraphs (e)(6)(ii) (A) through (C) of this section, a taxpayer may elect to allocate and apportion the

deduction for state income tax in accordance with one of the two safe harbor methods described in paragraph (e)(6)(ii)(D) (*2*) and (*3*) of this section. A taxpayer shall make this election for a taxable year by filing a timely tax return for that year that reflects an allocation and apportionment of the deduction for state income tax under one of the safe harbor methods and attaching to such return a statement that the taxpayer has elected to use the safe harbor method provided in either paragraph (e)(6)(ii)(D) (*2*) or (*3*) of this section, as appropriate. Once made, this election is effective for the taxable year for which made and all subsequent taxable years, and may be revoked only with the consent of the Commissioner. Example 33 of paragraph (g) of this section illustrates the application of these safe harbor methods.

(*2*) *Method One—*(*i*) *Step One—Specific allocation to foreign source portfolio dividends and other income.* If any portion of the deduction for state income tax is attributable to tax imposed by a state which includes in a corporate taxpayer's taxable income apportionable to the state, portfolio dividends (as defined in paragraph (i) of Example 28 of paragraph (g) of this section) that are treated under section 862(a)(2) as income from sources without the United States, but does not include factors of the corporations paying the portfolio dividends in the apportionment formula used to determine state taxable income, the taxpayer shall allocate an appropriate portion of the deduction to a class of gross income consisting solely of foreign source portfolio dividends. The portion of the deduction so allocated, and the amount of foreign source portfolio dividends included in such class, shall be determined in accordance with the methodology illustrated in paragraph (ii) of Example 28 of paragraph (g). If a state income tax is determined based upon formulary apportionment of the total taxable income attributable to the taxpayer's unitary business, the taxpayer must also apply the methodology illustrated in paragraph (ii) (C) through (G) of Example 29 of paragraph (g) of this section to make specific allocations of appropriate portions of the deduction for state income tax on the basis of income that, under separate accounting, would have been attributed to other members of the unitary group. The taxpayer shall reduce its aggregate state taxable income by the amount of foreign source portfolio dividends and other income to which a specific allocation is made (the reduced amount being referred to hereinafter as ''adjusted state taxable income'').

(*ii*) *Step Two—Adjustment of U.S. source federal taxable income.* If the taxpayer has significant income-producing activities in a state which does not impose a corporate income tax or other state tax measured by income derived from business activities in the state, the taxpayer shall reduce its U.S. source federal taxable income (solely for purposes of this safe harbor method) by the amount of federal taxable income attributable to its activities in such state. This amount shall be determined in accordance with the methodology illustrated in paragraph (ii) of Example 27 of paragraph (g) of this section, provided that the taxpayer shall be required to use the rules of the Uniform Division of Income for Tax Purposes Act to attribute income to the relevant state. The taxpayer's U.S. source federal taxable income, as so reduced, is referred to hereinafter as ''adjusted U.S. source federal taxable income.''

(*iii*) *Step Three—Allocation.* The taxpayer shall allocate the remainder of the deduction for state income tax (after reduction by the portion allocated to foreign source portfolio dividends and other income under Step One) in accordance with the methodology illustrated in paragraph (ii) of Example 25 of paragraph (g) of this section. However, the taxpayer shall substitute for the comparison of aggregate state taxable income to U.S. source federal taxable income, illustrated in paragraph (ii) of Example 25 of paragraph (g) of this section, a comparison of its adjusted state taxable income to an amount equal to 110% of its adjusted U.S. source federal taxable income.

(*iv*) *Step Four—Apportionment.* In the event that apportionment of the remainder of the deduction for state income tax is required, the taxpayer

shall apportion that remaining deduction to U.S. source income in accordance with the methodology illustrated in paragraph (iii) of Example 25 of paragraph (g) of this section, substituting for domestic source income in that paragraph an amount equal to 110% of the taxpayer's adjusted U.S. source federal taxable income. The remaining portion of the deduction shall be apportioned to the statutory groupings of foreign source income described in section 904(d) of the Code in accordance with the proportion of the income in each statutory grouping of foreign source income described in section 904(d) to the taxpayer's total foreign source federal taxable income (after reduction by the amount of foreign source portfolio dividends to which tax has been specifically allocated under Step One, above).

(*3*) *Method Two*—(*i*) *Step One—Specific allocation to foreign source portfolio dividends and other income.* Step One of this method is the same as Step One of Method One (as described in paragraph (e)(6)(ii)(D)(*2*)(*i*) of this section).

(*ii*) *Step Two—Adjustment of U.S. source federal taxable income.* Step Two of this method is the same as Step Two of Method One (as described in paragraph (e)(6)(ii)(D)(*2*)(*ii*) of this section).

(*iii*) *Step Three—Allocation.* The taxpayer shall allocate the remainder of the deduction for state income tax (after reduction by the portion allocated to foreign source portfolio dividends and other income under Step One) in accordance with the methodology illustrated in paragraph (ii) of Example 25 of paragraph (g) of this section. However, the taxpayer shall substitute for the comparison of aggregate state taxable income to U.S. source federal taxable income, illustrated in paragraph (ii) of Example 25 of paragraph (g) of this section, a comparison of its adjusted state taxable income to its adjusted U.S. source federal taxable income.

(*iv*) *Step Four—Apportionment.* In the event that apportionment of the deduction is required, the taxpayer shall apportion to U.S. source income that portion of the deduction that is attributable to state income taxes imposed upon an amount of state taxable income equal to adjusted U.S. source federal taxable income. The taxpayer shall apportion the remaining amount of the deduction to U.S. and foreign source income in the same proportions that the taxpayer's adjusted U.S. source federal taxable income and foreign source federal taxable income (after reduction by the amount of foreign source portfolio dividends to which tax has been specifically allocated under Step One, above) bear to its total federal taxable income (taking into account the adjustment of U.S. source federal taxable income under Step Two and after reduction by the amount of foreign source portfolio dividends to which tax has been specifically allocated under Step One). The portion of the deduction apportioned to foreign source income shall be apportioned among the statutory groupings described in section 904(d) of the Code in accordance with the proportions of the taxpayer's total foreign source federal taxable income (after reduction by the amount of foreign source portfolio dividends to which tax has been specifically allocated under Step One, above) in each grouping.

(iii) *Effective dates.* The rules of §1.861–8(e)(6)(i) and the language preceding the examples in §1.861–8(g) are effective for taxable years beginning after December 31, 1976. The rules of §1.861–8(e)(6)(ii) (other than §1.861–8(e)(6)(ii)(D)) and Examples 25 through 32 of §1.861–8(g) are effective for taxable years beginning on or after January 1, 1988. The rules of §1.861–8(e)(6)(ii)(D) and Example 33 of §1.861–8(g) are effective for taxable years ending after March 12, 1991. At the option of the taxpayer, however, the rules of §1.861–8(e)(6)(ii) (other than §1.861–8(e)(6)(ii)(D)) and Examples 25 through 32 of §1.861–8(g) may be applied with respect to deductions for state taxes incurred in taxable years beginning before January 1, 1988.

(7) *Losses on the sale, exchange, or other disposition of property*—(i) *Allocation.* The deduction allowed for loss recognized on the sale, exchange, or other disposition of a capital asset or property described in section 1231(b) shall be considered a deduction which is definitely related and allocable to the class of gross income to which such asset or property ordinarily gives rise

in the hands of the taxpayer. Where the nature of gross income generated from the asset or property has varied significantly over several taxable years of the taxpayer, such class of gross income shall generally be determined by reference to gross income generated from the asset or property during the taxable year or years immediately preceding the sale, exchange, or other dispostion of such asset or property. Thus, for example, where an asset generates primarily sales income from domestic sources in the early years of its operation and then is leased by the taxpayer to a foreign subsidiary in later years, the class of gross income to which the asset gives rise will be considered to be the rental income derived from the lease and will not include sales income from domestic sources.

(ii) *Apportionment of losses.* Where in the unusual circumstances that an apportionment of a deduction for losses on the sale, exchange, or other disposition of a capital asset or property described in section 1231(b) is necessary, the amount of such deduction shall be apportioned between the statutory grouping (or among the statutory groupings) of gross income (within the class of gross income) and the residual grouping (within the class of gross income) in the same proportion that the amount of gross income within such statutory grouping (or statutory groupings) and such residual grouping bear, respectively, to the total amount of gross income within the class of gross income. Apportionment will be necessary where, for example, the class of gross income to which the deduction is allocated consists of gross income (such as royalties) attributable to an intangible asset used both within and without the United States, or gross income (such as from sales or services) attributable to a tangible asset used both within and without the United States.

(iii) *Allocation of loss recognized in taxable years after 1986.* See §§1.865–1 and 1.865–2 for rules regarding the allocation of certain loss recognized in taxable years beginning after December 31, 1986.

(8) *Net operating loss deduction.* A net operating loss deduction allowed under section 172 shall be allocated and apportioned in the same manner as the deductions giving rise to the net operating loss deduction.

(9) *Deductions which are not definitely related.* Deductions which shall generally be considered as not definitely related to any gross income, and therefore are ratably apportioned as provided in paragraph (c)(3) of this section, are—

(i) The deduction allowed by section 163 for interest described in subparagraph (2)(iii) of this paragraph (e);

(ii) The deduction allowed by section 164 for real estate taxes on a personal residence or for sales tax on the purchase of items for personal use;

(iii) The deduction for medical expenses allowed by section 213; and

(iv) The deduction for alimony payments allowed by section 215.

(10) *Special deductions.* The special deductions allowed in the case of a corporation by section 241 (relating to the deductions for partially tax exempt interest, dividends received, etc.), section 922 (relating to Western Hemisphere trade corporations), and section 941 (relating to China Trade Act corporations) shall be allocated and apportioned consistent with the principles of this section.

(11) *Personal exemptions.* The deductions for the personal exemptions allowed by section 151, 642(b), or 873(b)(3) shall not be taken into account for purpose of allocation and apportionment under this section.

(12) *Deductions for certain charitable contributions*—(i) *In general.* The deduction for charitable contributions that is allowed under sections 170, 873(b)(2), and 882(c)(1)(B) is definitely related and allocable to all of the taxpayer's gross income. The deduction allocated under this paragraph (e)(12)(i) shall be apportioned between the statutory grouping (or among the statutory groupings) of gross income and the residual grouping on the basis of the relative amounts of gross income from sources in the United States in each grouping.

(ii) *Treaty provisions.* If a deduction for charitable contributions not otherwise permitted by sections 170, 873(b)(2), and 882(c)(1)(B) is allowed under a U.S. income tax treaty, and such treaty limits the amount of the

deduction based on a percentage of income arising from sources within the treaty partner, the deduction is definitely related and allocable to all of the taxpayer's gross income. The deduction allocated under this paragraph (e)(12)(ii) shall be apportioned between the statutory grouping (or among the statutory groupings) of gross income and the residual grouping on the basis of the relative amounts of gross income from sources within the treaty partner within each grouping.

(iii) *Coordination with §§ 1.861–14 and 1.861–14T.* A deduction for a charitable contribution by a member of an affiliated group shall be allocated and apportioned under the rules of this section, § 1.861–14(e)(6), and § 1.861–14T(c)(1).

(iv) *Effective date.* (A) The rules of paragraphs (e)(12)(i) and (iii) of this section shall apply to charitable contributions made on or after July 28, 2004. Taxpayers may apply the provisions of paragraphs (e)(12)(i) and (iii) of this section to charitable contributions made before July 28, 2004, but during the taxable year ending on or after July 28, 2004.

(B) The rules of paragraphs (e)(12)(ii) of this section shall apply to charitable contributions made on or after July 14, 2005. Taxpayers may apply the provisions of paragraph (e)(12)(ii) of this section to charitable contributions made before July 14, 2005, but during the taxable year ending on or after July 14, 2005.

(f) *Miscellaneous matters*—(1) *Operative sections.* The operative sections of the Code which require the determination of taxable income of the taxpayer from specific sources or activities and which give rise to statutory groupings to which this section is applicable include the sections described below.

(i) *Overall limitation to the foreign tax credit.* Under the overall limitation to the foreign tax credit, as provided in section 904(a)(2) (as in effect before enactment of the Tax Reform Act of 1976, or section 904(a) after such enactment) the amount of the foreign tax credit may not exceed the tentative U.S. tax (i.e., the U.S. tax before application of the foreign tax credit) multiplied by a fraction, the numerator of which is the taxable income from sources without the United States and the denominator of which is the entire taxable income. Accordingly, in this case, the statutory grouping is foreign source income (including, for example, interest received from a domestic corporation which meets the tests of section 861(a)(1)(B), dividends received from a domestic corporation which has an election in effect under section 936, and other types of income specified in section 862). Pursuant to sections 862(b) and 863(a) and §§ 1.862–1 and 1.863–1, this section provides rules for identifying the deductions to be taken into account in determining taxable income from sources without the United States. See section 904(d) (as in effect after enactment of the Tax Reform Act of 1976) and the regulations thereunder which require separate treatment of certain types of income. See example 3 of paragraph (g) of this section for one example of the application of this section to the overall limitation.

(ii) [Reserved]

(iii) *DISC and FSC taxable income.* Sections 925 and 994 provide rules for determining the taxable income of a FSC and DISC, respectively, with respect to qualified sales and leases of export property and qualified services. The combined taxable income method available for determining a DISC's taxable income provides, without consideration of export promotion expenses, that the taxable income of the DISC shall be 50 percent of the combined taxable income of the DISC and the related supplier derived from sales and leases of export property and from services. In the FSC context, the taxable income of the FSC equals 23 percent of the combined taxable income of the FSC and the related supplier. Pursuant to regulations under section 925 and 994, this section provides rules for determining the deductions to be taken into account in determining combined taxable income, except to the extent modified by the marginal costing rules set forth in the regulations under sections 925(b)(2) and 994(b)(2) if used by the taxpayer. See *Examples* (22) and (23) of paragraph (g) of this section. In addition, the computation of combined taxable income is necessary to determine the applicability of the section 925(d) limitation and the ''no loss''

rules of the regulations under sections 925 and 994.

(iv) *Effectively connected taxable income.* Nonresident alien individuals and foreign corporations engaged in trade or business within the United States, under sections 871(b)(1) and 882(a)(1), on taxable income which is effectively connected with the conduct of a trade or business within the United States. Such taxable income is determined in most instances by initially determining, under section 864(c), the amount of gross income which is effectively connected with the conduct of a trade or business within the United States. Pursuant to sections 873 and 882(c), this section is applicable for purposes of determining the deductions from such gross income (other than the deduction for interest expense allowed to foreign corporations (see §1.882–5)) which are to be taken into account in determining taxable income. See example 21 of paragraph (g) of this section.

(v) *Foreign base company income.* Section 954 defines the term ''foreign base company income'' with respect to controlled foreign corporations. Section 954(b)(5) provides that in determining foreign base company income the gross income shall be reduced by the deductions of the controlled foreign corporation ''properly allocable to such income''. This section provides rules for identifying which deductions are properly allocable to foreign base company income.

(vi) *Other operative sections.* The rules provided in this section also apply in determining—

(A) The amount of foreign source items of tax preference under section 58(g) determined for purposes of the minimum tax;

(B) The amount of foreign mineral income under section 901(e);

(C) [Reserved]

(D) The amount of foreign oil and gas extraction income and the amount of foreign oil related income under section 907;

(E) The tax base for individuals entitled to the benefits of section 931 and the section 936 tax credit of a domestic corporation that has an election in effect under section 936;

(F) The exclusion for income from Puerto Rico for bona fide residents of Puerto Rico under section 933;

(G) The limitation under section 934 on the maximum reduction in income tax liability incurred to the Virgin Islands;

(H) The income derived from the U.S. Virgin Islands or from a section 935 possession (as defined in §1.935–1(a)(3)(i)).

(I) The special deduction granted to China Trade Act corporations under section 941;

(J) The amount of certain U.S. source income excluded from the subpart F income of a controlled foreign corporation under section 952(b);

(K) The amount of income from the insurance of U.S. risks under section 953(b)(5);

(L) The international boycott factor and the specifically attributable taxes and income under section 999; and

(M) The taxable income attributable to the operation of an agreement vessel under section 607 of the Merchant Marine Act of 1936, as amended, and the Capital Construction Fund Regulations thereunder (26 CFR, part 3). See 26 CFR 3.2(b)(3).

(2) *Application to more than one operative section.* (i) Where more than one operative section applies, it may be necessary for the taxpayer to apply this section separately for each applicable operative section. In such a case, the taxpayer is required to use the same method of allocation and the same principles of apportionment for all operative sections.

(ii) When expenses, losses, and other deductions that have been properly allocated and apportioned between combined gross income of a related supplier and a DISC or former DISC and residual gross income, regardless of which of the administrative pricing methods of section 994 has been applied, such deductions are not also allocated and apportioned to gross income consisting of distributions from the DISC or former DISC attributable to income of the DISC or former DISC as determined under the administrative pricing methods with respect to DISC or former DISC taxable years beginning after December 31, 1986. Accordingly, *Example* (22) of paragraph (g) of

this section does not apply to distributions from a DISC or former DISC with respect to DISC or former DISC taxable years beginning after December 31, 1986. This rule does not apply to the extent that the taxable income of the DISC or former DISC is determined under the section 994(a)(3) transfer pricing method. In addition, for taxable years beginning after December 31, 1986, in the case of expenses, losses, and other deductions that have been properly allocated and apportioned between combined gross income of a related supplier and a FSC and residual gross income, regardless of which of the administrative pricing methods of section 925 has been applied, such deductions are not also allocated and apportioned to gross income consisting of distributions from the FSC or former FSC which are attributable to the foreign trade income of the FSC or former FSC as determined under the administrative pricing methods. This rule does not apply to the extent that the foreign trade income of the FSC or former FSC is determined under the section 925(a)(3) transfer pricing method. See *Example* (23) of paragraph (g) of this section.

(3) *Special rules of section 863(b)*—(i) *In general*. Special rules under section 863(b) provide for the application of rules of general apportionment provided in §§1.863–3 to 1.863–5, to worldwide taxable income in order to attribute part of such worldwide taxable income to U.S. sources and the remainder of such worldwide taxable income to foreign sources. The activities specified in section 863(b) are—

(A) Transportation or other services rendered partly within and partly without the United States,

(B) Sales of personal property produced by the taxpayer within and sold without the United States, or produced by the taxpayer without and sold within the United States, and

(C) Sales within the United States of personal property purchased within a possession of the United States.

In the instances provided in §§1.863–3 and 1.863–4 with respect to the activities described in (A), (B), and (C) of this subdivision, this section is applicable only in determining worldwide taxable income attributable to these activities.

(ii) *Relationship of sections 861, 862, 863(a), and 863(b)*. Sections 861, 862, 863(a), and 863(b) are the four provisions applicable in determining taxable income from specific sources. Each of these four provisions applies independently. Where a deduction has been allocated and apportioned to income under one of these four provisions, the deduction shall not again be allocated and apportioned to gross income under any of the other three provisions. However, two or more of these provisions may have to be applied at the same time to determine the proper allocation and apportionment of a deduction. The special rules under section 863(b) take precedence over the general rules of Code sections 861, 862 and 863(a). For example, where a deduction is allocable in whole or in part to gross income to which section 863(b) applies, such deduction or part thereof shall not otherwise be allocated under section 861, 862, or 863(a). However, where the gross income to which the deduction is allocable includes both gross income to which section 863(b) applies and gross income to which section 861, 862, or 863(a) applies, more than one section must be applied at the same time in order to determine the proper allocation and apportionment of the deduction.

(4) *Adjustments made under other provisions of the Code*—(i) *In general*. If an adjustment which affects the taxpayer is made under section 482 or any other provision of the Code, it may be necessary to recompute the allocations and apportionments required by this section in order to reflect changes resulting from the adjustment. The recomputation made by the Commissioner shall be made using the same method of allocation and apportionment as was originally used by the taxpayer, provided such method as originally used conformed with paragraph (a)(2) of this section and, in light of the adjustment, such method does not result in a material distortion. In addition to adjustments which would be made aside from this section, adjustments to the taxpayer's income and deductions which would not otherwise be made may be required before applying this section in order to prevent a distortion in determining taxable income

from a particular source of activity. For example, if an item included as a part of the cost of goods sold has been improperly attributed to specific sales, and, as a result, gross income under one of the operative sections referred to in paragraph (f)(1) of this section is improperly determined, it may be necessary for the Commissioner to make an adjustment to the cost of goods sold, consistent with the principles of this section, before applying this section. Similarly, if a domestic corporation transfers the stock in its foreign subsidiaries to a domestic subsidiary and the parent corporation continues to incur expenses in connection with protecting its capital investment in the foreign subsidiaries (*see* paragraph (e)(4) of this section), it may be necessary for the Commissioner to make an allocation under section 482 with respect to such expenses before making allocations and apportionments required by this section, even though the section 482 allocation might not otherwise be made.

(ii) *Example*. X, a domestic corporation, purchases and sells consumer items in the United States and foreign markets. Its sales in foreign markets are made to related foreign subsidiaries. X reported $1,500,000 as sales during the taxable year of which $1,000,000 was domestic sales and $500,000 was foreign sales. X took a deduction for expenses incurred by its marketing department during the taxable year in the amount of $150,000. These expenses were determined to be allocable to both domestic and foreign sales and are apportionable between such sales. Thus, X allocated and apportioned the marketing department deduction as follows:

To gross income from domestic sales: $150,000 × ($1,000,000/$1,500,000)	$100,000
To gross income from foreign sales: $150,000 × ($500,000/$1,500,000)	50,000
Total	150,000

On audit of X's return for the taxable year, the District Director adjusted, under section 482, X's sales to related foreign subsidiaries by increasing the sales price by a total of $100,000, thereby increasing X's foreign sales and total sales by the same amount. As a result of the section 482 adjustment, the apportionment of the deduction for the marketing department expenses is redetermined as follows:

To gross income from domestic sales: $150,000 × ($1,000,000/$1,600,000)	$93,750
To gross income from foreign sales: $150,000 × ($600,000/$1,600,000)	56,250
Total	150,000

(5) *Verification of allocations and apportionments*. Since, under this section, allocations and apportionments are made on the basis of the factual relationship between deductions and gross income, the taxpayer is required to furnish, at the request of the District Director, information from which such factual relationships can be determined. In reviewing the overall limitation to the foreign tax credit of a domestic corporation, for example, the District Director should consider information which would enable him to determine the extent to which deductions attributable to functions performed in the United States are related to earning foreign source income, United States source income, or income from both sources. In addition to functions with a specific international purpose, consideration should be given to the functions of management, the direction and results of an acquisition program, the functions of operating units and personnel located at the head office, the functions of support units (including but not limited to engineering, legal, budget, accounting, and industrial relations), the functions of selling and advertising units and personnel, the direction and uses of research and development and the direction and uses of services furnished by independent contractors. Thus, for example when requested by the District Director, the taxpayer shall make available any of its organization charts, manuals, and other writings which relate to the manner in which its gross income arises and to the functions of organizational units, employees, and assets of the taxpayer and arrange for the interview of such of its employees as the District Director deems desirable in order to determine the gross income to which deductions relate. See section 7602 and the regulations thereunder which generally provide for the examination of books and witnesses. See also section 905(b) and the regulations thereunder which require proof of foreign tax credits to the satisfaction of the Secretary or his delegate.

(g) *General examples*. The following examples illustrate the principles of this section. In each example, unless otherwise specified, the operative section which is applied and gives rise to the statutory grouping of gross income is the overall limitation to the foreign tax credit under section 904(a). In addition, in each example, where a method of allocation or apportionment is illustrated as an acceptable method, it is assumed that such method is used by the taxpayer on a consistent basis from year to year (except in the case of the optional method for apportioning research and development expense under paragraph (e)(3)(iii) of §1.861–8). Further, it is assumed that each party named in each example operates on a calendar year accounting basis and, where the party is a U.S. taxpayer, files returns on a calendar year basis.

Examples 1–16 [Reserved]

Example 17. Stewardship expenses (consolidation). (i) (A) *Facts*. X, a domestic corporation, wholly owns M, N, and O, also domestic corporations. X, M, N, and O file a consolidated income tax return. All the income of X and O is from sources within the United States, all of M's income is general category income from sources within South America, and all of N's income is general category income from sources within Africa. X receives no dividends from M, N, or O. During the taxable year, the consolidated group of corporations earned consolidated gross income of $550,000 and incurred total deductions of $370,000 as follows:

	Gross income	Deductions
Corporations:		
X	$100,000	$50,000
M	250,000	100,000
N	150,000	200,000
O	50,000	20,000
Total	550,000	370,000

(B) Of the $50,000 of deductions incurred by X, $15,000 relates to X's ownership of M; $10,000 relates to X's ownership of N; $5,000 relates to X's ownership of O; and the sole effect of the entire $30,000 of deductions is to protect X's capital investment in M, N, and O. X properly categorizes the $30,000 of deductions as stewardship expenses. The remainder of X's deductions ($20,000) relates to production of United States source income from its plant in the United States.

(ii) (A) *Allocation*. X's deductions of $50,000 are definitely related and thus allocable to the types of gross income to which they give rise, namely $25,000 wholly to general category income from sources outside the United States ($15,000 for stewardship of M and $10,000 for stewardship of N) and the remainder ($25,000) wholly to gross income from sources within the United States. Expenses incurred by M and N are entirely related and thus wholly allocable to general category income earned from sources without the United States, and expenses incurred by O are entirely related and thus wholly allocable to income earned within the United States. Hence, no apportionment of expenses of X, M, N, or O is necessary. For purposes of applying the foreign tax credit limitation, the statutory grouping is general category gross income from sources without the United States and the residual grouping is gross income from sources with in the United States. As a result of the allocation of deductions, the X consolidated group has taxable income from sources without the United States in the amount of $75,000, computed as follows:

Foreign source general category gross income ($250,000 from M + $150,000 from N)	$400,000
Less: Deductions allocable to foreign source general category gross income ($25,000 from X, $100,000 from M, and $200,000 from N)	(325,000)
Total foreign-source taxable income	75,000

(B) Thus, in the combined computation of the general category limitation, the numerator of the limiting fraction (taxable income from sources outside the United States) is $75,000.

Example 18. Stewardship and supportive expenses. (i) (A) *Facts*. X, a domestic corporation, manufactures and sells pharmaceuticals in the United States. X's domestic subsidiary S, and X's foreign subsidiaries T, U, and V perform similar functions in the United States and foreign countries T, U, and V, respectively. Each corporation derives substantial net income during the taxable year that is general category income described in section 904(d)(1). X's gross income for the taxable year consists of:

Domestic sales income	$32,000,000
Dividends from S (before dividends received deduction)	3,000,000
Dividends from T	2,000,000
Dividends from U	1,000,000
Dividends from V	0
Royalties from T and U	1,000,000

Fees from U for services performed by X	1,000,000
Total gross income	40,000,000

(B) In addition, X incurs expenses of its supervision department of $1,500,000.

(C) X's supervision department (the Department) is responsible for the supervision of its four subsidiaries and for rendering certain services to the subsidiaries, and this Department provides all the supportive functions necessary for X's foreign activities. The Department performs three principal types of activities. The first type consists of services for the direct benefit of U for which a fee is paid by U to X. The cost of the services for U is $900,000 (which results in a total charge to U of $1,000,000). The second type consists of activities described in §1.482–9(l)(3)(iii) that are in the nature of shareholder oversight that duplicate functions performed by the subsidiaries' own employees and that do not provide an additional benefit to the subsidiaries. For example, a team of auditors from X's accounting department periodically audits the subsidiaries' books and prepares internal reports for use by X's management. Similarly, X's treasurer periodically reviews for the board of directors of X the subsidiaries' financial policies. These activities do not provide an additional benefit to the related corporations. The cost of the duplicative services and related supportive expenses is $540,000. The third type of activity consists of providing services which are ancillary to the license agreements which X maintains with subsidiaries T and U. The cost of the ancillary services is $60,000.

(ii) *Allocation*. The Department's outlay of $900,000 for services rendered for the benefit of U is allocated to the $1,000,000 in fees paid by U. The remaining $600,000 in the Department's deductions are definitely related to the types of gross income to which they give rise, namely dividends from subsidiaries S, T, U, and V and royalties from T and U. However, $60,000 of the $600,000 in deductions are found to be attributable to the ancillary services and are definitely related (and therefore allocable) solely to royalties received from T and U, while the remaining $540,000 in deductions are definitely related (and therefore allocable) to dividends received from all the subsidiaries.

(iii) (A) *Apportionment*. For purposes of applying the foreign tax credit limitation, the statutory grouping is general category gross income from sources outside the United States and the residual grouping is gross income from sources within the United States. X's deduction of $540,000 for the Department's expenses and related supportive expenses which are allocable to dividends received from the subsidiaries must be apportioned between the statutory and residual groupings before the foreign tax credit limitation may be applied. In determining an appropriate method for apportioning the $540,000, a basis other than X's gross income must be used since the dividend payment policies of the subsidiaries bear no relationship either to the activities of the Department or to the amount of income earned by each subsidiary. This is evidenced by the fact that V paid no dividends during the year, whereas S, T, and U paid dividends of $1 million or more each. In the absence of facts that would indicate a material distortion resulting from the use of such method, the stewardship expenses ($540,000) may be apportioned on the basis of the gross receipts of each subsidiary.

(B) The gross receipts of the subsidiaries were as follows:

S	$4,000,000
T	3,000,000
U	500,000
V	1,500,000
Total	9,000,000

(C) Thus, the expenses of the Department are apportioned for purposes of the foreign tax credit limitation as follows:

Apportionment of stewardship expenses to the statutory grouping of gross income: $540,000 × [($3,000,000 + $500,000 + $1,500,000)/$9,000,000]	$300,000
Apportionment of supervisory expenses to the residual grouping of gross income: $540,000 × [$4,000,000/9,000,000]	240,000
Total: Apportioned stewardship expense	540,000

Example 19. Supportive Expense. (i) *Facts.* X, a domestic corporation, purchases and sells products both in the United States and in foreign countries. X has no foreign subsidiary and no international department. During the taxable year, X incurs the following expenses with respect to its worldwide activities:

Personnel department expenses	$50,000
Training department expenses	35,000
General and administrative expenses	55,000
President's salary	40,000
Sales manager's salary	20,000
Total	200,000

X has domestic gross receipts from sales of $750,000 and foreign gross receipts from sales of $500,000 and has gross income from such sales in the same ratio, namely $300,000 from domestic sources and $200,000 from foreign sources.

(ii) *Allocation*. The above expenses are definitely related and allocable to all of X's gross income derived from both domestic and foreign markets.

(iii) *Apportionment*. For purposes of applying the overall limitation, the statutory grouping is gross income from sources outside the United States and the residual grouping is gross income from sources within the United States. X's deductions for its worldwide sales activities must be apportioned between these groupings. Company X in this example (unlike Company X in example 18) does not have a separate international division which performs essentially all of the functions required to manage and oversee its foreign activities. The president and sales manager do not maintain time records. The division of their time between domestic and foreign activities varies from day to day and cannot be estimated on an annual basis with any reasonable degree of accuracy. Similarly, there are no facts which would justify a method of apportionment of their salaries or of one of the other listed deductions based on more specific factors than gross receipts or gross income. An acceptable method of apportionment would be on the basis of gross receipts. The apportionment of the $200,000 deduction is as follows:

Apportionment of the $200,000 expense to the statutory grouping of gross income: $200,000 × [$500,000/($500,000 + $750,000)]	$80,000
Apportionment of the $200,000 expense to the residual grouping of gross income: $200,000 × [$750,000/($500,000 + $750,000)]	120,000
Total apportioned supportive expense	200,000

Example 20. Supportive Expense. (i) *Facts*. Assume the same facts as above except that X's president devotes only 5 percent of his time to the foreign operations and 95 percent of his time to the domestic operations and that X's sales manager devotes approximately 10 percent of his time to foreign sales and 90 percent of his time to domestic sales.

(ii) *Allocation*. The expenses incurred by X with respect to its worldwide activities are definitely related, and therefore allocable to X's gross income from both its foreign and domestic markets.

(iii) *Apportionment*. On the basis of the additional facts it is not acceptable to apportion the salaries of the president and the sales manager on the basis of gross receipts. It is acceptable to apportion such salaries between the statutory grouping (gross income from sources without the United States) and residual grouping (gross income from sources within the United States) on the basis of time devoted to each sales activity. Remaining expenses may still be apportioned on the basis of gross receipts. The apportionment is as follows:

Apportionment of the $200,000 expense to the statutory grouping of gross income:	
President's salary: $40,000 × 5 pct	$2,000
Sales manager's salary: $20,000 × 10 pct	2,000
Remaining expenses: $140,000 × [$500,000/($500,000 + $750,000)]	56,000
Subtotal: Apportionment of expense to statutory grouping	60,000
Apportionment of the $200,000 expense to the residual grouping of gross income:	
President's salary: $40,000 × 95 pct	38,000
Sales manager's salary: $20,000 × 90 pct	18,000
Remaining expenses: $140,000 × [$750,000/($500,000 + $750,000)]	84,000
Subtotal: Apportionment of expense to residual grouping	140,000
Total: Apportioned general and administrative expense	200,000

Example 21. Supportive Expense. (i) *Facts*. X, a foreign corporation doing business in the United States, is a manufacturer of metal stamping machines. X has no United States subsidiaries and no separate division to manage and oversee its business in the United States. X manufactures and sells these machines in the United States and in foreign countries A and B and has a separate manufacturing facility in each country. Sales of these machines are X's only source of income. In 1977, X incurs general and administrative expenses related to both its U.S. and foreign operations of $100,000. It has machine sales of $500,000, $1,000,000 and $1,000,000 on which it earns gross income of $200,000, $400,000 and $400,000 in the United States, country A, and country B, respectively. The income from the manufacture and sale of the machines in countries A and B is not effectively connected with X's business in the United States.

(ii) *Allocation*. The $100,000 of general and administrative expense is definitely related to the income to which it gives rise, namely a part of the gross income from sales of machines in the United States, in country A, and in country B. The expenses are allocable to this class of income, even though X's gross income from sources outside the United States is excluded income since it is not effectively connected with a U.S. trade or business.

(iii) *Apportionment* Since X is a foreign corporation, the statutory grouping is gross income effectively connected with X's trade of business in the United States, namely gross income from sources within the United States, and the residual grouping is gross income not effectively connected with a trade or business in the United States, namely gross income from countries A and B. Since there are no facts which would require a method of apportionment other than on the

basis of sales or gross income, the amount may be apportioned between the two groupings on the basis of amounts of gross income as follows:

Apportionment of general and administrative expense to the statutory grouping, gross income from sources within the United States: $100,000 × [$200,000/($200,000 + $400,000 + $400,000)]	$20,000
Apportionment of general and administrative expense to the residual grouping, gross income from sources without the United States: $100,000 × [($400,000 + $400,000)/($200,000 + $400,000 + $400,000)]	80,000
Total apportioned general and administrative expense	100,000

Example 22. Domestic International Sales Corporations. (i) *Facts.* X, a domestic corporation, manufactures a line of kitchenware and sells it to retailers in the United States, France, and the United Kingdom. After the Domestic International Sales Corporation (DISC) legislation was passed in 1971, X established, as of January 1, 1972, a DISC and thereafter did all of its foreign marketing through sales by the DISC. In 1977 the DISC has total sales of $7,700,000 for which X's cost of goods sold is $6,000,000. Thus, the gross income attributable to exports through the DISC is $1,700,000 ($7,700,000 − $6,000,000). Moreover, X has U.S. domestic sales of kitchenware of $12,000,000 on which it earned gross income of $900,000, and X receives royalty income from the foreign license of its kitchenware technology in the amount of $800,000. The DISC's expenses attributable to the resale of export property are $400,000 of which $300,000 qualify as export promotion expenses. X also incurs $125,000 of general and administrative expenses in connection with its domestic and foreign sales activities, and its foreign licensing activities. X and the DISC determine transfer prices charged on the basis of a single product grouping and the ''50–50'' combined taxable income method (without marginal costing) which permits the DISC to have a taxable income equal to 50 percent of the combined taxable income attributable to the production and sales of the export property, plus 10 percent of the DISC's export promotion expenses.

(ii) *Allocation.* For purposes of determining combined taxable income of X and the DISC from export sales, general and administrative expenses of $125,000 must be allocated to and apportioned between gross income resulting from the production and sale of kitchenware for export, and from the production and sale of kitchenware for the domestic market. The deduction of $400,000 for expenses attributable to the resale of export property is allocated solely to gross income from the production and sale of kitchenware in foreign markets.

(iii) *Apportionment.* Apportionment of expense takes place in two stages. In the first stage, for computing conbined taxable income from the production and sale of export property, the general and administrative expense should be apportioned between the statutory grouping of gross income from the export of kitchenware and the residual grouping of gross income from domestic sales and foreign licenses. In the second stage, since the limitation on the foreign tax credit requires the use of a separate limitation with respect to dividends from a DISC (section 904(d)), the general and administrative expense should be apportioned between two statutory groupings, DISC dividends and foreign royalty income (for which the overall limitation is used), and the residual grouping of gross income from sales within the United States. In the first stage, in the absence of more specific or contrary information, the general and administrative expense may be apportioned on the basis of gross income in the respective groupings, as follows:

Apportionment of general and administrative expense to the statutory grouping, gross income from exports of kitchenware: $125,000 × [$1,700,000/($1,700,000 + $900,000 + $800,000)]	$62,500
Apportionment of general and administrative expense to the residual grouping, gross income from domestic sales of kitchenware and foreign royalty income from licensing kitchenware technology: $125,000 × [($900,000 + $800,000)/($1,700,000 + $900,000 + $800,000)]	62,500
Total apportionment of general and administrative expense	125,000

On the basis of this apportionment, the combined taxable income, and the DISC portion of taxable income may be calculated as follows:

Gross income from exports	$1,700,000	
Less:		
DISC expense for resale of export property	400,000	
Apportioned general and administrative expense	62,500	
		$462,500
Combined taxable income from production and export of kitchenware		1,237,500
DISC income:		
50 pct of combined taxable income		618,750
10 pct of export promotion expense of $300,000		30,000
Total DISC income		648,750
DISC income as a percentage of combined taxable income		52.4

In the second stage, in the absence of more specific or contrary information, the general and administrative expense may also be apportioned on the basis of gross income in the respective groupings. Since DISC taxable income is 52.4 percent of combined taxable income, DISC gross income is treated as 52.4 percent of the gross income from exports $1,700,000. The apportionment follows:

Apportionment of general and administrative expense to the statutory grouping, DISC dividends: $125,000 × [(0.524 × $1,700,000)/($1,700,000 + $900,000 + $800,000)]	$32,750
Apportionment of general and administrative expense to the statutory grouping, foreign royalty income: $125,000 × [$800,000/($1,700,000 + 900,000 + $800,000)]	29,412
Apportionment of general and administrative expense to the residual grouping, gross income from sources within the United States: $125,000 × [($900,000 + (0.476 × $1,700,000))/($1,700,000 + $900,000 + $800,000)]	62,838
Total apportioned general and administrative expense	125,000

(iv) This *Example* 22 applies only to DISC taxable years ending before January 1, 1987, and to distributions from a DISC or former DISC with respect to DISC or former DISC taxable years ending before January 1, 1987.

Example 23. [Reserved]

Example 24. [Reserved]. For guidance, see § 1.861–8T(g) *Example* 24.

Example 25. Income Taxes. (i) *Facts.* X, a domestic corporation, is a manufacturer and distributor of electronic equipment with operations in states A, B, and C. X also has a branch in country Y which manufactures and distributes the same type of electronic equipment. In 1988, X has taxable income from these activities, as described under the Code (without taking into account the deduction for state income taxes), of $1,000,000, of which $200,000 is foreign source general limitation income subject to a separate limitation under section 904(d)(1)(I) (''general limitation income'') and $800,000 is domestic source income. States A, B, and C each determine X's income subject to tax within their state by making adjustments to X's taxable income as determined under the Code, and then apportioning the adjusted taxable income on the basis of the relative amounts of X's payroll, property, and sales within each state as compared to X's worldwide payroll, property, and sales. The adjustments made by states A, B, and C all involve adding and subtracting enumerated items from taxable income as determined under the Code. However, in making these adjustments to taxable income, none of the states specifically exempts foreign source income as determined under the Code. On this basis, it is determined that X has taxable income of $550,000, $200,000, and $200,000 in states A, B, and C, respectively. The corporate tax rates in states A, B, and C are 10 percent, 5 percent, and 2 percent, respectively, and X has total state income tax liabilities of $69,000 ($55,000 + $10,000 + $4,000), which it deducts as an expense for federal income tax purposes.

(ii) *Allocation.* X's deduction of $69,000 for state income taxes is definitely related and thus allocable to the gross income with respect to which the taxes are imposed. Since the statutes of states A, B, and C do not specifically exempt foreign source income (as determined under the Code) from taxation and since, in the aggregate, states A, B, and C tax $950,000 of X's income while only $800,000 is domestic source income under the Code, it is presumed that state income taxes are imposed on $150,000 of foreign source income. The deduction for state income taxes is therefore related and allocable to both X's foreign source and domestic source income.

(iii) *Apportionment.* For purposes of computing the foreign tax credit limitation, X's income is comprised of one statutory grouping, foreign source general limitation gross income, and one residual grouping, gross income from sources within the United States. The state income tax deduction of $69,000 must be apportioned between these two groupings. Corporation X calculates the apportionment on the basis of the relative amounts of foreign source general limitation taxable income and U.S. source taxable income subject to state taxation. In this case, state income taxes are presumed to be imposed on $800,000 of domestic source income and $150,000 of foreign source general limitation income.

State income tax deduction apportioned to foreign source general limitation income (statutory grouping): $69,000 × ($150,000/$950,000)	$10,895
State income tax deduction apportioned to income from sources within the United States (residual grouping): $69,000 × ($800,000/$950,000)	58,105
Total apportioned state income tax deduction	$69,000

Example 26. Income Taxes. (i) *Facts.* Assume the same facts as in Example 25 except that the language of state A's statute and the statute's operation exempt from taxation all foreign source income, as determined under the Code, so that foreign source income is not included in adjusted taxable income subject to apportionment in state A (and factors relating to X's country Y branch are not taken into account in computing the state A apportionment fraction).

(ii) *Allocation.* X's deduction of $69,000 for state income taxes is definitely related and thus allocable to the gross income with respect to which the taxes are imposed. Since state A exempts all foreign source income by statute, state A is presumed to impose tax on $550,000 of X's $800,000 of domestic source income. X's state A tax of $55,000 is allocable, therefore, solely to domestic source income. Since the statutes of states B and C do not specifically exclude all foreign source income as determined under the Code, and since states B and C impose tax on $400,000 ($200,000 + $200,000) of X's income of which

only $250,000 ($800,000 − $550,000) is presumed to be domestic source, the deduction for the $14,000 of income taxes imposed by states B and C is related and allocable to both foreign source and domestic source income.

(iii) *Apportionment.* (A) For purposes of computing the foreign tax credit limitation, X's income is comprised of one statutory grouping, foreign source general limitation gross income, and one residual grouping, gross income from sources within the United States. The deduction of $14,000 for income taxes of states B and C must be apportioned between these two groupings.

(B) Corporation X calculates the apportionment on the basis of the relative amounts of foreign source general limitation income and U.S. source income subject to state taxation.

States B and C income tax deduction apportioned to foreign source general limitation income (statutory grouping): $14,000 × ($150,000/$400,000)	$5,250
States B and C income tax deduction apportioned to income from sources within the United States (residual grouping): $14,000 × ($250,000/$400,000)	8,750
Total apportioned state income tax deduction	$14,000

(C) Of X's total income taxes of $69,000, the amount allocated and apportioned to foreign source general limitation income equals $5,250. The total amount of state income taxes allocated and apportioned to U.S. source income equals $63,750 ($55,000 + $8,750).

Example 27. Income Tax. (i) *Facts.* Assume the same facts as in Example 25 except that state A, in which X has significant income-producing activities, does not impose a corporate income tax or other state tax computed on the basis of income derived from business activities conducted in state A. X therefore has a total state income tax liability in 1988 of $14,000 ($10,000 paid to state B plus $4,000 paid to state C), all of which is subject to allocation and apportionment under paragraph (b) of this section.

(ii) *Allocation.* (A) X's deduction of $14,000 for state income taxes is definitely related and allocable to the gross income with respect to which the taxes are imposed. However, in these facts, an adjustment is necessary before the aggregate state taxable incomes can be compared with U.S. source income on the federal income tax return in the manner described in Examples 25 and 26. Unlike the facts in Examples 25 and 26, state A imposes no income tax and does not define taxable income attributable to activities in state A. The total amount of X's income subject to state taxation is, therefore, $400,000 ($200,000 in state B and $200,000 in state C). This total presumptively does not include any income attributable to activities performed in state A and therefore can not properly be compared to total U.S. source taxable income reported by X for federal income tax purposes, which does include income attributable to state A activities.

(B)(1) Accordingly, before applying the method used in Examples 25 and 26 to the facts of this example, it is necessary first to estimate the amount of taxable income that state A could reasonably attribute to X's activities in state A, and then to reduce federal taxable income by that amount.

(2) Any reasonable method may be used to attribute taxable income to X's activities in state A. For example, the rules of the Uniform Division of Income for Tax Purposes Act (''UDITPA'') attribute income to a state on the basis of the average of three ratios that are based upon the taxpayer's facts—property within the state over total property, payroll within the state over total payroll, and sales within the state over total sales—and, with adjustments, provide a reasonable method for this purpose. When applying the rules of UDITPA to estimate U.S. source income derived from state A activities, the taxpayer's UDITPA factors must be adjusted to eliminate both taxable income and factors attributable to a foreign branch. Therefore, in this example all taxable income as well as UDITPA apportionment factors (property, payroll, and sales) attributable to X's country Y branch must be eliminated.

(C)(1) Since it is presumed that, if state A had had an income tax, state A would not attempt to tax the income derived by X's country Y branch, any reasonable estimate of the income that would be taxed by state A must exclude any foreign source income.

(2) When using the rules of UDITPA to estimate the income that would have been taxable by state A in these facts, foreign source income is excluded by starting with federally defined taxable income (before deduction for state income taxes) and subtracting any income derived by X's country Y branch. The hypothetical state A taxable income is then determined by multiplying the resulting difference by the average of X's state A property, payroll, and sales ratios, determined using the principles of UDITPA (after adjustment by eliminating the country Y branch factors). The resulting product is presumed to be exclusively U.S. source income, and the allocation and apportionment method described in Example 26 must then be applied.

(3) If, for example, state A taxable income were determined to equal $550,000, then $550,000 of U.S. source income for federal income tax purposes would be presumed to constitute state A taxable income. Under Example 26, the remaining $250,000 ($800,000 − $550,000) of U.S. source income for federal income tax purposes would be presumed to be subject to tax in states B and C. Since states

B and C impose tax on $400,000, the application of Example 25 would result in a presumption that $150,000 is foreign source income and $250,000 is domestic source income. The deduction for the $14,000 of income taxes of states B and C would therefore be related and allocable to both foreign source and domestic source income and would be subject to apportionment.

(iii) *Apportionment.* The deduction of $14,000 for income taxes of states B and C is apportioned in the same manner as in Example 26. As a result, $5,250 of the $14,000 of state B and state C income taxes is apportioned to foreign source general limitation income ($14,000 × $150,000/$400,000), and $8,750 ($14,000 × $250,000/$400,000) of the $14,000 of state B and state C income taxes is apportioned to U.S. source income.

Example 28. Income Tax. (i) *Facts.* (A) Assume the same facts as in Example 25 (X has $1,000,000 of taxable income for federal income tax purposes, $800,000 of which is U.S. source income and $200,000 of which is foreign source general limitation income), except that $100,000 of X's $200,000 of foreign source general limitation income consists of dividends from first-tier controlled foreign corporations (''CFCs'') (as defined in section 957(a) of the Code) which derive exclusively foreign source general limitation income. X owns stock representing 10 to 50 percent of the vote and value in such CFCs.

(B) State A taxable income is computed by first making adjustments to X's federal taxable income. These adjustments result in X having a total of $1,100,000 of apportionable taxable income for state A tax purposes. None of the $100,000 of adjustments made by state A relate to the dividends paid by the CFCs. As in Example 25, the amount of apportionable taxable income attributable to business activities conducted in state A is determined by multiplying apportionable taxable income by a fraction (the ''state apportionment fraction'') that compares the relative amounts of X's payroll, property, and sales within state A with X's worldwide payroll, property and sales. An analysis of state A law indicates that state A law includes in its definition of the taxable business income of X which is apportionable to X's state A activities, dividends paid to X by its subsidiaries that are in the same business as X, but are less than 50 percent owned by X (''portfolio dividends''). The dividends received by X from the 10 to 50 percent owned first-tier CFCs, therefore, are considered to be portfolio dividends includable in apportionable business income for state A tax purposes. However, the factors of these CFCs are not included in the state A apportionment fraction for purposes of apportioning income to X's activities in the state. The comparison of X's state A factors with X's worldwide factors results in a state apportionment fraction of 50 percent. Applying this fraction to apportionable taxable income of $1,100,000, as determined under state law, results in attributing 50 percent of apportionable taxable income to state A, and produces total state A taxable income of $550,000. State A imposes an income tax at a rate of 10 percent on the amount of income that is attributed to state A, which results in $55,000 of tax imposed by state A.

(ii) *Allocation.* (A) States A, B, and C impose income taxes of $69,000 which must be allocated to the classes of gross income upon which the taxes are imposed. A portion of X's federal income tax dedution of $55,000 for state A income tax is definitely related and thus allocable to the class of gross income consisting of foreign source portfolio dividends. A definite relationship exists between a deduction for state income tax and portfolio dividends when a state includes portfolio dividends in state taxable income apportionable to the state, but determines state taxable income by applying an apportionment fraction that excludes the factors of the corporations paying those dividends. By applying a state apportionment fraction that excludes factors of the corporations paying portfolio dividends to apportionable taxable income that includes the $100,000 of foreign source portfolio dividends, $50,000 (50 percent of the $100,000) of the portfolio dividends is attributed to X's activities in state A and subjected to state A income tax. Applying the state A income tax rate of 10 percent to the $50,000 of foreign source portfolio dividends subjected to state A income tax, $5,000 of X's $55,000 total state A income tax liability is definitely related and allocable to a class of gross income consisting of the foreign source portfolio dividends. Since under the look-through rules of section 904(d)(3) the foreign source portfolio dividends from the first-tier CFCs are included within the general limitation described in section 904(d)(1)(I), the $5,000 of state A tax on foreign source portfolio dividends is allocated entirely to foreign source general limitation income and, therefore, is not apportioned. (If the total amount of state A tax imposed on foreign source portfolio dividends were to exceed the actual amount of X's state A income tax liability (for example, due to net operating losses), the actual amount of state A tax would be allocated entirely to those foreign source portfolio dividends.) After allocation of a portion of the state A tax to portfolio dividends, $50,000 ($55,000 − $5,000) of state A tax remains to be allocated.

(B) A total of $64,000 (the aggregate of the $50,000 remaining state A tax, and the $10,000 and $4,000 of taxes imposed by states B and C, respectively) is to be allocated (as provided in Example 25) by comparing U.S. source taxable income (as determined under the Code) with the aggregate of the state taxable incomes determined by states A, B, and C (after reducing state apportionable taxable

incomes by the amount of any portfolio dividends included in apportionable taxable income to which tax has been specifically allocated). X's state A taxable income, after reduction by the $50,000 of portfolio dividends taxed by state A, equals $500,000. X also has taxable income of $200,000 and $200,000 in states B and C, respectively. In the aggregate, therefore, states A, B, and C tax $900,000 of X's income, after excluding state taxable income attributable to portfolio dividends. Since X has only $800,000 of U.S. source taxable income for federal income tax purposes, it is presumed that state income taxes are imposed on $100,000 of foreign source income. The remaining deduction of $64,000 for state income taxes is therefore related and allocable to both foreign source and domestic source income and is subject to apportionment.

(iii) *Apportionment.* For purposes of computing the foreign tax credit limitation, X's income is comprised of one statutory grouping, foreign source general limitation income, and one residual grouping, gross income from sources within the United States. The remaining state income tax deduction of $64,000 must be apportioned between these two groupings on the basis of relative amounts of foreign source general limitation taxable income and U.S. source taxable income subject to state taxation. In this case, the $64,000 of state income taxes is considered to be imposed on $800,000 of domestic source income and $100,000 of foreign source general limitation income and is apportioned as follows:

State income tax deduction apportioned to foreign source general limitation income (statutory grouping): $64,000 × ($100,000/$900,000)	$7,111
State income tax deduction apportioned to income from sources within the United States (residual grouping): $64,000 × ($800,000/$900,000)	56,889
Total apportioned state income tax deduction	$64,000

Of the total state income taxes of $69,000, the amount allocated and apportioned to foreign source general limitation income equals $12,111 ($5,000 + $7,111). The total amount of state income taxes allocated and apportioned to U.S. source income equals $56,889.

Example 29. Income Taxes. (i) *Facts.* (A) P, a domestic corporation, is a manufacturer and distributor of electronic equipment with operations in states F, G, and H. P also has a branch in country Y which manufactures and distributes the same type of electronic equipment. In addition, P has three wholly owned subsidiaries, US1, US2, and FS, the latter a controlled foreign corporation (''CFC'') as defined in section 957(a) of the Code. P also owns stock representing 10 to 50 percent of the vote and value of various other first-tier CFCs that derive exclusively foreign source general limitation income.

(B) In 1988, P derives $1,000,000 of federal taxable income (without taking into account the deduction for state income taxes), which consists of $250,000 of foreign source general limitation income and $750,000 of U.S. source income. The foreign source general limitation income consists of a $25,000 subpart F inclusion with respect to FS, $150,000 of dividends from the other first-tier CFCs deriving exclusively foreign source general limitation income, in which P owns stock representing 10 to 50 percent of the vote and value, and $75,000 of manufacturing and sales income derived by P's U.S. operations and country Y branch. The $750,000 of U.S. source income consists of manufacturing and sales income derived by P's U.S. operations.

(C) For federal income tax purposes, US1 derives $75,000 of taxable income, before deduction for state income taxes, which consists entirely of U.S. source income. US2, a so-called ''80/20'' corporation described in section 861(c)(1), derives $250,000 of federal taxable income before deduction for state or foreign income taxes, all of which is derived from foreign operations and consists entirely of foreign source general limitation income. FS is not engaged in a U.S. trade or business and derives $550,000 of foreign source general limitation income before deduction for foreign income taxes.

(D) State F imposes a corporate income tax of 10 percent of P's state F taxable income, which is determined by formulary apportionment of the total taxable income attributable to P's worldwide unitary business. State F determines P's taxable income for state F tax purposes by first making adjustments to the taxable income, as determined for federal income tax purposes, of the members of the unitary business group to determine the total taxable income of the group. State F then computes P's state taxable income by attributing a portion of that unitary business taxable income to activities of P that are conducted in state F. State F does this by multiplying the unitary business taxable income (federal taxable income with state adjustments) by a fraction (the ''state apportionment fraction'') that compares the relative amounts of the unitary business group's payroll, property, and sales (the ''factors'') in state F with the payroll, property, and sales of the unitary business group. P is the only member of its unitary business group that has state F factors and that is thereby subject to state F income tax and filing requirements. State F defines the unitary business group to include any corporation more than 50 percent of which is directly or indirectly owned by a state F taxpayer and is engaged in the same unitary

business. P's unitary business group, therefore, includes P, US1, US2, and FS, but does not include the 10 to 50 percent owned CFCs. The income of the unitary business group excludes intercompany dividends between members of the unitary business group and subpart F inclusions with respect to a member of the unitary business group. Dividends paid from nonmembers of the unitary group (the 10 to 50 percent owned CFCs) for state F tax purposes are referred to as ''portfolio dividends'' and are included in taxable income of the unitary business. None of the factors (in state F or worldwide) of the corporations paying portfolio dividends are included in the state F apportionment fraction for purposes of apportioning total taxable income of the unitary business to P's state F activities.

(E) After state adjustments to the taxable income of the unitary business group, as determined under federal tax principles, the total taxable income of P's unitary business group equals $2,000,000, consisting of $1,050,000 of P's income ($100,000 of foreign source manufacturing and sales income, $150,000 of foreign source portfolio dividends, and $800,000 of U.S. source manufacturing and sales income, but excluding the $25,000 subpart F inclusion attributable to FS since FS is a member of the unitary business group), $100,000 of US1's income (from sales made in the United States), $275,000 of US2's income (from an active business outside the United States), and $575,000 of FS's income. The differences between taxable income under federal tax principles and state F apportionable taxable income for P, US1, US2, and FS represent adjustments to taxable income under federal tax principles that are made pursuant to the tax laws of state F.

(F) The taxable income for each member of the unitary business group under federal tax principles and state law principles is summarized in the following table. (The items of income listed in the ''Federal'' column of the table refer to taxable income before deduction for state income tax.)

	Federal	State F
P		
U.S. source income	$750,000	$800,000
Foreign source general limitation income:		
Portfolio dividends	150,000	150,000
Subpart F income	25,000	0
Manufacturing and sales income	75,000	100,000
Total taxable income	1,000,000	1,050,000
US1		
U.S. source income	75,000	100,000
US2		
Foreign source general limitation income	250,000	275,000
FS		
Foreign source general limitation income	550,000	575,000
Taxable income of the unitary business group	.....	2,000,000

(G) State F deems P to have state F taxable income of $500,000, which is determined by multiplying the total taxable income of the unitary business group ($2,000,000) by the group's state F apportionment fraction, which is assumed to be 25 percent in these facts. P's state F taxable income is then multiplied by the state F tax rate of 10 percent, resulting in a state F tax liability of $50,000. State G and state H, unlike state F, do not tax portfolio dividends. Although state G and state H apportion taxable income, respectively, on the basis of an apportionment fraction that compares state factors to total factors, state G and state H, unlike state F, do not apply a unitary business theory and consider only P's taxable income and factors in computing P's taxable income. P's taxable income under state G law equals $300,000, which is subject to a 5 percent tax rate resulting in a state G tax liability of $15,000. P's taxable income under state H law is $300,000, which is subject to a tax rate of 2 percent resulting in a state H tax liability of $6,000. P has a total federal income tax deduction for state income taxes of $71,000 ($50,000 + 15,000 + 6,000).

(ii) *Allocation.* (A) P's deduction of $71,000 for state income taxes is definitely related and allocable to the gross income with respect to which the taxes are imposed. Adjustments may be necessary, however, before aggregate state taxable incomes can be compared with U.S. source taxable income on the federal income tax return in the manner described in Examples 25 and 26. In allocating P's deduction for state income taxes, it is necessary first to determine the portion, if any, of the deduction that is definitely related and allocable to a particular class of gross income. A definite relationship exists between a deduction for state income tax and dividend income when a state includes portfolio dividends in state taxable income apportionable to the taxpayer's activities in the state, but determines state taxable income by applying an apportionment formula that excludes the factors of the corporations paying portfolio dividends.

(B) In this case, $150,000 of foreign source portfolio dividends are subject to a state F apportionment fraction of 25 percent, which results in a total of $37,500 of state F taxable income attributable to such dividends. As illustrated in Example 28, $3,750 ($150,000 × 25 percent state F apportionment percentage ×

10 percent state F tax rate) of P's state F income tax is definitely related and allocable to a class of gross income consisting entirely of the foreign source portfolio dividends. Since under the look-through rules of section 904(d)(3) the foreign source portfolio dividends paid by first-tier CFCs are included within the general limitation described in section 904(d)(1)(I), the $3,750 of state F tax on foreign source portfolio dividends is allocated entirely to foreign source general limitation income and, therefore, is not apportioned.

(C) After reducing state F taxable income of the unitary business group by the taxable income attributable to portfolio dividends, P's remaining state F taxable income equals $462,500 ($500,000 − $37,500), the portion of the taxable income of the unitary business that state F attributes to P's activities in state F. Accordingly, in order to allocate and apportion the remaining $46,250 of state F tax ($50,000 of state F tax minus the $3,750 of state F tax allocated to foreign source portfolio dividends), it is necessary first to determine if state F is taxing only P's non-unitary taxable income (as defined below) or is imposing its tax partly on other unitary business income that is attributed under state F law to P's activities in state F. P's state F non-unitary taxable income is computed by applying the state F apportionment formula, solely on the basis of P's income (excluding portfolio dividends) and state F apportionment factors. If the state F taxable income (after reduction by the portfolio dividends attributed to state F) attributed to P under state F law exceeds P's non-unitary taxable income, a portion of the state F tax must be allocated and apportioned on the basis of the other unitary business income that is attributed to and taxable to P under state F law. If P's non-unitary taxable income equals or exceeds the $462,500 of remaining state F taxable income, it is presumed that state F is only taxing P's non-unitary taxable income, so that the entire amount of the remaining state F tax should be allocated and apportioned in the manner described in Example 25.

(D) If P's non-unitary taxable income is less than the $462,500 of remaining state F taxable income (after reduction for the $37,500 of state F taxable income attributable to portfolio dividends), it is presumed that state F is attributing to P, and taxing P upon, other unitary business income. In such a case, it is necessary to determine if state F is attributing to P, and imposing its income tax on, a part of the foreign source income that would be generally presumed under separate accounting to be the income of foreign affiliates and 80/20 companies included in the unitary group, or whether state F is limiting the income it attributes to P, and its taxation of P, to the U.S. source income that would be generally presumed under separate accounting to be the income of domestic members of the unitary group.

(E) Assume for purposes of this example that the non-unitary taxable income attributable to P equals $396,000, computed by multiplying P's state F taxable income of $900,000 (P's state F taxable income (before state F apportionment) of $1,050,000 less the $150,000 of foreign source portfolio dividends) by P's non-unitary state F apportionment fraction, which is assumed to be 44 percent. Because P's non-unitary taxable income of $396,000 is less than the $462,500 of remaining state F taxable income, state F is presumed to be attributing to P and taxing the income that would have been generally attributed under separate accounting to P's affiliates in the unitary group. To determine if state F tax is being imposed on members of the unitary group (other that P) that produce foreign source income, it is necessary to compute a hypothetical state F taxable income for all companies in the unitary group with significant U.S. operations. (For this purpose, the hypothetical group of companies with significant domestic operations is referred to as the ''water's edge group.'') State F is presumed to be attributing to P and taxing income that would have been generally attributable under separate accounting to foreign corporations and 80/20 companies to the extent that the remaining state F taxable income ($462,500) of P exceeds the hypothetical state F taxable income that would have been attributed under state F law to P if state F had defined the unitary group to be the water's edge group.

(F) The members of the water's edge group would have been P and US1. The unitary business income of this water's edge group is $1,000,000, the sum of $900,000 (P's state F taxable income (before state F apportionment) of $1,050,000 less the $150,000 of foreign source portfolio dividends) and $100,000 (US1's state F taxable income). For purposes of this example, the state F apportionment fraction determined on a unitary basis for this water's edge group is assumed to equal 40 percent, the average of P and US1's state F payroll, property, and sales factor ratios (the water's edge group's state F factors over its worldwide factors). Applying this apportionment fraction to the $1,000,000 of unitary business income of the water's edge group yields state F water's edge taxable income of $400,000. The excess of the remaining $462,500 of P's state F taxable income over the $400,000 of P's state F water's edge taxable income equals $62,500, and is attributable to the inclusion of US2 and FS in the unitary group. The state F tax attributable to the $62,500 of taxable income attributed to P under state F law, and that would have generally been attributed to US2 and FS under non-unitary accounting, equals $6,250 and is allocated entirely to a class of gross income

consisting of foreign source general limitation income, because the income of FS and US2 consists entirely of such income. After the $6,250 of state F tax attributable to US2 and FS is subtracted from the remaining $46,250 of net state F tax, P has $40,000 of state F tax remaining to be allocated and apportioned.

(G) To the extent that the remainder of P's state F taxable income ($400,000) exceeds P's non-unitary state F taxable income ($396,000), it is presumed that state F is attributing to and imposing on P a tax on U.S. source income that would have been attributed under separate accounting to members of the water's edge group other than P. In these facts, the $4,000 difference in P's state F taxable income results from the inclusion of US1 in the unitary group. The $400 of P's state F tax attributable to this $4,000 is allocated entirely to P's U.S. source income. P's remaining $39,600 of state F tax ($40,000 of P's state F tax resulting from the attribution of P of income that would have been attributed under non-unitary accounting to other members of the water's edge group, minus $400 of state F tax attributable to US1 and allocated to P's U.S. source income) is the state F tax attributable to P's non-unitary state F taxable income that is to be allocated and apportioned together with P's state G tax of $15,000 and state H tax of $6,000 as illustrated in Example 25.

(H) In allocating the $60,600 of state tax liabilities ($39,600 state F tax attributable to P's non-unitary state F income + $15,000 state G tax + $6,000 state H tax) under Example 25, P's state taxable income in state G and state H ($300,000 + $300,000) must be added to P's non-unitary state F taxable income ($396,000). The resulting $996,000 of combined state taxable incomes is compared with $750,000 of U.S. source income on P's federal income tax return. Because P's combined state taxable incomes exceeds P's federal U.S. source taxable income, it is presumed that the remaining $60,600 of P's total state income taxes is imposed in part on foreign source income. Accordingly, P's remaining deduction of $60,600 ($39,600 + $15,000 + $6,000) for state income taxes is related and allocable to both P's foreign source and domestic source income and is subject to apportionment.

(iii) *Apportionment*. The $60,600 of state taxes (the remaining $39,600 of state F tax + $15,000 of state G tax + $6,000 of state H tax) must be apportioned between foreign source general limitation income and U.S. source income for federal income tax purposes. This apportionment is based upon the relative amounts of foreign source general limitation taxable income and U.S. source taxable income comprising the $996,000 of income subject to tax by the states, after reducing the total amount of income subject to tax by the portfolio dividends and the income attributed to P under state F law that would have been attributed under arm's length principles to other members of P's state F unitary business group. The deduction for the $60,600 of state income taxes is apportioned as follows:

State income tax deduction apportioned to foreign source general limitation income (statutory grouping): $60,600 × ($246,000/$996,000)	$14,967
State income tax deduction apportioned to income from sources within the United States (residual grouping): $60,600 × ($750,000/$996,000)	45,633
Total apportioned state income tax deduction	60,600

Of the total state income taxes of $71,000, the amount allocated and apportioned to foreign source general limitation income is $24,967—the sum of $14,967 of state F, state G, and state H taxes apportioned to foreign source general limitation income, $3,750 of state F tax allocated to foreign source apportionable dividend income, and the $6,250 of state F tax allocated to foreign source general limitation income as the result of state F's worldwide unitary business theory of taxation. The total amount of state income taxes allocated and apportioned to U.S. source income equals $46,033—the sum of the $400 of state F tax attributable to the inclusion of US1 in the state F unitary business group and $45,633 of combined state F, G, and H tax apportioned under the method provided in Example 25.

Example 30. Income taxes. (i)(A) *Facts.* As in *Example 17* of this paragraph (g), X is a domestic corporation that wholly owns M, N, and O, also domestic corporations. X, M, N, and O file a consolidated income tax return. All the income of X and O is from sources within the United States, all of M's income is general category income from sources within South America, and all of N's income is general category income from sources within Africa. X receives no dividends from M, N, or O. During the taxable year, the consolidated group of corporations earned consolidated gross income of $550,000 and incurred total deductions of $370,000. X has gross income of $100,000 and deductions of $50,000, without regard to its deduction for state income tax. Of the $50,000 of deductions incurred by X, $15,000 relates to X's ownership of M; $10,000 relates to X's ownership of N; $5,000 relates to X's ownership of O; and the entire $30,000 constitutes stewardship expenses. The remainder of X's $20,000 of deductions (which is assumed not to include state income tax) relates to production of U.S. source income from its plant in the United States. M has gross income of $250,000 and deductions of $100,000, which yield foreign-source general category taxable income of $150,000. N has gross income of $150,000 and deductions of $200,000, which yield a foreign-source general category loss of $50,000. O has

gross income of $50,000 and deductions of $20,000, which yield U.S. source taxable income of $30,000.

(B) Unlike *Example 17* of this paragraph (g), however, X also has a deduction of $1,800 for state A income taxes. X's state A taxable income is computed by first making adjustments to the Federal taxable income of X to derive apportionable taxable income for state A tax purposes. An analysis of state A law indicates that state A law also includes in its definition of the taxable business income of X which is apportionable to X's state A activities, the taxable income of M, N, and O, which is related to X's business. As in *Example 25* of this paragraph (g), the amount of apportionable taxable income attributable to business activities conducted in state A is determined by multiplying apportionable taxable income by a fraction (the ''state apportionment fraction'') that compares the relative amounts of payroll, property, and sales within state A with worldwide payroll, property, and sales. Assuming that X's apportionable taxable income equals $180,000, $100,000 of which is from sources without the United States, and $80,000 is from sources within the United States, and that the state apportionment fraction is equal to 10 percent, X has state A taxable income of $18,000. The state A income tax of $1,800 is then derived by applying the state A income tax rate of 10 percent to the $18,000 of state A taxable income.

(ii) *Allocation and apportionment.* Assume that under *Example 29* of this paragraph (g), it is determined that X's deduction for state A income tax is definitely related to a class of gross income consisting of income from sources both within and without the United States, and that the state A tax is apportioned $1,000 to sources without the United States, and $800 to sources within the United States. Under *Example 17* of this paragraph (g), without regard to the deduction for X's state A income tax, X has a separate loss of ($25,000) from sources without the United States. After taking into account the deduction for state A income tax, X's separate loss from sources without the United States is increased by the $1,000 state A tax apportioned to sources without the United States, and equals a loss of ($26,000), for purposes of computing the numerator of the consolidated general category foreign tax credit limitation.

Example 31. Income Taxes. (i) *Facts.* Assume that the facts are the same as in Example 29, except that state G requires P to adjust its federal taxable income by depreciating an asset at a different rate than is allowed P under the Internal Revenue Code for the same asset. Before using the methodology of Example 25 to determine whether a portion of its deduction for state income taxes is allocable to a class of gross income that includes foreign source income, P recomputes its taxable income under state G law by using the rate of depreciation that it is entitled to use under the Code, and uses this recomputed amount in applying the methodology of Example 25.

(ii) *Allocation.* P's modification of its state G taxable income is permissible. Under the methdology of Example 25, this modification of state G taxable income will produce a reasonable determination of the portion (if any) of P's state income taxes that is allocable to a class of gross income that includes foreign sources income.

Example 32. Income Taxes. (i) *Facts.* Assume the facts are the same as Example 29, except that P's state F taxable income differs from the amount of its U.S. source income under federal income tax principles solely because state F determines P's state taxable income under a worldwide unitary business theory instead of the arm's length principles applied in the Code. Before using the methodology of Example 25 to determine whether a portion of its deduction for state income taxes is allocable to a class of gross income that includes foreign source income, P recomputes state F taxable income under the arm's length principles applied in the Code. P substitutes that recomputed amount for the amount of taxable income actually determined under state F law in applying the methodology of Example 25.

(ii) *Allocation.* P's modification of state F taxable income does not accurately reflect the factual relationship between the deduction for state F income tax and the income on which the tax is imposed, because there is no factual relationship between the state F income tax and the state F taxable income as recomputed under Code principles. State F does not impose its income tax upon P's income as it might have been defined under the Internal Revenue Code. Consequently, P's modification of state F taxable income is impermissible because it will not produce a reasonable determination of the portion (if any) of P's state income taxes that is allocable to a class of gross income that includes foreign source income.

Example 33. Income Taxes. (i) *Facts.* Assume the same facts as in Example 29, except that state G does not impose an income tax on corporations, and P's non-unitary state F taxable income equals $462,500. Thus only $56,000 of state income taxes ($50,000 of state F income tax and $6,000 of state H income tax) are deductible and required to be allocated and (if necessary) apportioned. As in Example 29, P has $800,000 of aggregate state taxable income ($500,000 of state F taxable income and $300,000 of state H taxable income).

(ii) *Method One.* Assume that P has elected to allocate and apportion its deduction for state income tax under the safe harbor method provided in §1.861–8 (e)(6)(ii)(D)(*2*) (''Method One'').

(A) *Step One—Specific allocation to foreign source portfolio dividends.* P applies the methodology of paragraph (ii) of *Example 28* to determine the portion of the deduction that must be allocated to a class of gross income consisting solely of foreign source portfolio dividends. As illustrated in paragraphs (ii)(A) and (B) of Example 29, $3,750 of the deduction for state F income tax is attributable to the $37,500 of foreign source portfolio dividends attributed under state F law to P's activities in state F. Thus $3,750 of P's deduction for state income tax must be specifically allocated to a class of gross income consisting solely of $37,500 of foreign source portfolio dividends. No apportionment of the $3,750 is necessary. P's adjusted state taxable income is $762,500 (aggregate state taxable income of $800,000 reduced by $37,500 of foreign source portfolio dividends). Because the remaining amount of state F taxable income ($462,500) equals P's non-unitary state F taxable income, no further specific allocation of state tax is required.

(B) *Step Two—Adjustment of U.S. source federal taxable income.* P applies the methodology illustrated in paragraph (ii) of Example 27 (including the rules of UDITPA described therein) to determine the amount of its federal taxable income attributable to its activities in state G. Assume that P determines under this methodology that $300,000 of its federal taxable income is attributable to activities in state G. P's adjusted U.S. source federal taxable income equals $450,000 ($750,000 minus the $300,000 attributed to P's activities in state G).

(C) *Step Three—Allocation.* The portion of P's deduction for state income tax remaining to be allocated equals $52,250 ($56,000 minus the $3,750 specifically allocated to foreign source portfolio dividends). P allocates this portion by applying the methodology illustrated in paragraph (ii) of Example 25, as modified by paragraph (e)(6)(ii)(D)(*2*)(*iii*) of this section. Thus, P compares its adjusted state taxable inocme (as determined under Step One in paragraph (A) above) with an amount equal to 110% of its adjusted U.S. source federal taxable income (as determined under Step Two in paragraph (B) above). Because P's adjusted state taxable income ($762,500) exceeds 110% of P's adjusted U.S. source federal taxable income ($495,000, or 110% of $450,000), the remaining portion of P's deduction for state income tax ($52,500) must be allocated to a class of gross income that includes both U.S. and foreign source income.

(D) *Step Four—Apportionment.* P must apportion to U.S. source income the portion of the deduction that is attributable to state income tax imposed upon state taxable income in an amount equal to 110% of P's adjusted U.S. source federal taxable income. The remainder of the deduction must be apportioned to foreign source general limitation income.

Amount of deduction to be apportioned	$52,250.00
Less portion of deduction to be apportioned to income from sources within the United States (residual grouping): ($52,250 × ($495,000/$762,500)	$33,919.67
Equals Portion of deduction to be apportioned to foreign source general limitation income (statutory grouping):	$18,330.33

(iii) *Method Two.* Assume that P has elected to allocate and apportion its deduction for state income tax under the safe harbor method provided in § 1.861–8(e)(6)(ii)(D)(*3*) (''Method Two'').

(A) *Step One—Specific allocation.* Step One of Method Two is the same as Step One of Method One. Therefore, as described in paragraph (A) of paragraph (ii) above, $3,750 of P's deduction for state income tax must be specifically allocated to a class of gross income consisting solely of $37,500 of foreign source portfolio dividends. No apportionment of the $3,750 is necessary. P's adjusted state taxable income is $762,500 (aggregate state taxable income of $800,000 reduced by $37,500 of foreign source portfolio dividends).

(B) *Step Two—Adjustment of U.S. source federal taxable income.* Step Two of Method Two is the same as Step Two of Method One. Therefore, as described in paragraph (B) of paragraph (ii) above, assume that P determines that $300,000 of its federal taxable income is attributable to activities in state G. P's adjusted U.S. source federal taxable income equals $450,000 ($750,000 minus the $300,000 attributed to P's activities in state G).

(C) *Step Three—Allocation.* The portion of P's deduction for state income tax remaining to be allocated equals $52,250 ($56,000 minus the $3,750 of state F income tax specifically allocated to foreign source portfolio dividends). P allocates this portion by applying the methodology illustrated in paragraph (ii) of Example 25, as modified by paragraph (e)(6)(ii)(D)(*3*)(*iii*) of this section. Thus, P compares its adjusted state taxable income (as determined under Step One in paragraph (A) above) with its adjusted U.S. source federal taxable income (as determined under Step Two in paragraph (B) above). Because P's adjusted state taxable income ($762,500) exceeds P's adjusted U.S. source federal taxable income ($450,000), the remaining portion of P's deduction for state income tax ($52,500) must be allocated to a class of gross income that includes both U.S. and foreign source income.

(D) *Step Four—Apportionment.* P must apportion to U.S. source income the portion of the deduction that is attributable to state income tax imposed upon state taxable income in an amount equal to P's adjusted U.S. source federal taxable income.

Amount of deduction to be apportioned	$52,250.00

Less portion of deduction initially apportioned to income from sources within the United States (residual grouping): $52,250 × ($450,000/$762,500)	30,836.07
Remainder requiring further apportionment: $52,250 × ($312,500/$762,500)	21,413.93

The remainder of $21,413.93 must be further apportioned between foreign source general limitation income and U.S. source federal taxable income in the same proportions that P's adjusted U.S. source federal taxable income and foreign source general limitation income bear to P's total federal taxable income (taking into account the adjustment of U.S. source federal taxable income and reduced by the amount of foreign source portfolio dividends to which the tax has been specifically allocated).

Portion of remainder apportioned to foreign source general limitation income (statutory grouping): $21,413.93 × ($212,500/$662,500)	$6,868.62
Remaining state income tax deduction to be apportioned to income from sources within the United States (residual grouping): $21,413.93 × ($450,000/$662,500)	$14,545.31

Of P's total deduction of $56,000 for state income tax, the portion allocated and apportioned to foreign source general limitation income equals $10,618.62—the sum of $6,868.62 apportioned under Step Four and the $3,750.00 specifically allocated to foreign source portfolio dividend income under Step One. The portion of the deduction allocated and apportioned to U.S. source income equals $45,381.38—the sum of the $30,836.07 and the $14,545.31 apportioned under Step Four.

[T.D. 7456, 42 FR 1195, Jan. 6, 1977]

EDITORIAL NOTE: For FEDERAL REGISTER citations affecting § 1.861–8, see the List of CFR Sections Affected, which appears in the Finding Aids section of the printed volume and at *www.fdsys.gov*.

EDITORIAL NOTE: At 74 FR 38872, Aug. 4, 2009, § 1.861–8 was amended; however, the amendment to revise paragraph (h) could not be incorporated due to inaccurate amendatory instruction.

§ 1.861–8T Computation of taxable income from sources within the United States and from other sources and activities (temporary).

(a) *In general.* (1) [Reserved]

(2) *Allocation and apportionment of deductions in general.* If an affiliated group of corporations joins in filing a consolidated return under section 1501, the provisions of this section are to be applied separately to each member in that affiliated group for purposes of determining such member's taxable income, except to the extent that expenses, losses, and other deductions are allocated and apportioned as if all domestic members of an affiliated group were a single corporation under section 864(e) and the regulations thereunder. See § 1.861–9T through § 1.861–11T for rules regarding the affiliated group allocation and apportionment of interest expense, and § 1.861–14T for rules regarding the affiliated group allocation and apportionment of expenses other than interest.

(a)(3) through (b) [Reserved] For further guidance, *see* § 1.861–8(a)(3) through (b).

(c) *Apportionment of deductions*—(1) *Deductions definitely related to a class of gross income.* Where a deduction has been allocated in accordance with paragraph (b) of this section to a class of gross income which is included in one statutory grouping and the residual grouping, the deduction must be apportioned between the statutory grouping and the residual grouping. Where a deduction has been allocated to a class of gross income which is included in more than one statutory grouping, such deduction must be apportioned among the statutory groupings and, where necessary, the residual grouping. Thus, in determining the separate limitations on the foreign tax credit imposed by section 904(d)(1) or by section 907, the income within a separate limitation category constitutes a statutory grouping of income and all other income not within that separate limitation category (whether domestic or within a different separate limitation category) constitutes the residual grouping. In this regard, the same method of apportionment must be used in apportioning a deduction to each separate limitation category. Also, see paragraph (f)(1)(iii) of this section with respect to the apportionment of deductions among the statutory groupings designated in section 904(d)(1). If the class of gross income to which a deduction has been allocated consists entirely of a single statutory grouping or the residual grouping, there is no need to apportion that deduction. If a deduction is not definitely related to any gross income, it must be apportioned ratably as provided in

paragraph (c)(3) of this section. A deduction is apportioned by attributing the deduction to gross income (within the class to which the deduction has been allocated) which is in one or more statutory groupings and to gross income (within the class) which is in the residual grouping. Such attribution must be accomplished in a manner which reflects to a reasonably close extent the factual relationship between the deduction and the grouping of gross income. In apportioning deductions, it may be that for the taxable year there is no gross income in the statutory grouping or that deductions will exceed the amount of gross income in the statutory grouping. See paragraph (d)(1) of this section with respect to cases in which deductions exceed gross income. In determining the method of apportionment for a specific deduction, examples of bases and factors which should be considered include, but are not limited to—

(i) Comparison of units sold,

(ii) Comparison of the amount of gross sales or receipts,

(iii) Comparison of costs of goods sold,

(iv) Comparison of profit contribution,

(v) Comparison of expenses incurred, assets used, salaries paid, space utilized, and time spent which are attributable to the activities or properties giving rise to the class of gross income, and

(iv) Comparison of the amount of gross income.

Paragraph (e) (2) through (8) of this section provides the applicable rules for allocation and apportionment of deductions for interest, research and development expenses, and certain other deductions. The effects on tax liability of the apportionment of deductions and the burden of maintaining records not otherwise maintained and making computations not otherwise made shall be taken into consideration in determining whether a method of apportionment and its application are sufficiently precise. A method of apportionment described in this paragraph (c)(1) may not be used when it does not reflect, to a reasonably close extent, the factual relationship between the deduction and the groupings of income. Furthermore, certain methods of apportionment described in this paragraph (c)(1) may not be used in connection with any deduction for which another method is prescribed. The principles set forth above are applicable in apportioning both deductions definitely related to a class which constitutes less than all of the taxpayer's gross income and to deductions related to all of the taxpayer's gross income. If a deduction is not related to any class of gross income, it must be apportioned ratably as provided in paragraph (c)(3) of this section.

(2) *Apportionment based on assets.* Certain taxpayers are required by paragraph (e)(2) of this section and § 1.861–9T to apportion interest expense on the basis of assets. A taxpayer may apportion other deductions based on the comparative value of assets that generate income within each grouping, provided that such method reflects the factual relationship between the deduction and the groupings of income and is applied in accordance with the rules of § 1.861–9T(g). In general, such apportionments must be made either on the basis of the tax book value of those assets or on their fair market value. However, once the taxpayer uses fair market value, the taxpayer and all related persons must continue to use such method unless expressly authorized by the Commissioner to change methods. For purposes of this paragraph (c)(2) the term *related persons* means two or more persons in a relationship described in section 267(b). In determining whether two or more corporations are members of same controlled group under section 267(b)(3), a person is considered to own stock owned directly by such person, stock owned with the application of section 1563(e)(1), and stock owned by the application of section 267(c). In determining whether a corporation is related to a partnership under section 267(b)(10), a person is considered to own the partnership interest owned directly by such person and the partnership interest owned with the application of section 267(e)(3). In the case of any corporate taxpayer that—

(i) Uses tax book value, and

(ii) Owns directly or indirectly (within the meaning of § 1.861–11T(b)(2)(ii)) 10

percent or more of the total combined voting power of all classes of stock entitled to vote in any other corporation (domestic or foreign) that is not a member of the affiliated group (as defined in section 864(e)(5)), such taxpayer shall adjust its basis in that stock in the manner described in § 1.861–11T(b).

(3) [Reserved]

(d) *Excess of deductions and excluded and eliminated items of income.* (1) [Reserved]

(2) *Allocation and apportionment to exempt, excluded or eliminated income*—(i) *In general.* In the case of taxable years beginning after December 31, 1986, except to the extent otherwise permitted by § 1.861–13T, the following rules shall apply to take account of income that is exempt or excluded, or assets generating such income, with respect to allocation and apportionment of deductions.

(A) *Allocation of deductions.* In allocating deductions that are definitely related to one or more classes of gross income, exempt income (as defined in paragraph (d)(2)(ii) of this section) shall be taken into account.

(B) *Apportionment of deductions.* In apportioning deductions that are definitely related either to a class of gross income consisting of multiple groupings of income (whether statutory or residual) or to all gross income, exempt income and exempt assets (as defined in paragraph (d)(2)(ii) of this section) shall not be taken into account.

For purposes of apportioning deductions which are not taken into account under § 1.1502–13 in determining gain or loss from intercompany transactions, as defined in § 1.1502–13, income from such transactions shall be taken into account in the year such income is ultimately included in gross income.

(ii) *Exempt income and exempt asset defined*—(A) *In general.* For purposes of this section, the term *exempt income* means any income that is, in whole or in part, exempt, excluded, or eliminated for federal income tax purposes. The term *exempt asset* means any asset the income from which is, in whole or in part, exempt, excluded, or eliminated for federal tax purposes.

(B) *Certain stock and dividends.* The term ''exempt income'' includes the portion of the dividends that are deductible under—

(*1*) Section 243(a) (1) or (2) (relating to the dividends received deduction),

(*2*) Section 245(a) (relating to the dividends received deduction for dividends from certain foreign corporations).

Thus, for purposes of apportioning deductions using a gross income method, gross income would not include a dividend to the extent that it gives rise to a dividend received deduction under either section 243(a)(1), section 243(a)(2), or section 245(a). In the case of a life insurance company taxable under section 801, the amount of such stock that is treated as tax exempt shall not be reduced because a portion of the dividends received deduction is disallowed as attributable to the policyholder's share of such dividends. See § 1.861–14T(h) for a special rule concerning the allocation of reserve expenses of a life insurance company. In addition, for purposes of apportioning deductions using an asset method, assets would not include that portion of stock equal to the portion of dividends paid thereon that would be deductible under either section 243(a)(1), section 243(a)(2), or section 245(a). In the case of stock which generates, has generated, or can reasonably be expected to generate qualifying dividends deductible under section 243(a)(3), such stock shall not constitute a tax exempt asset. Such stock and the dividends thereon will, however, be eliminated from consideration in the apportionment of interest expense under the consolidation rule set forth in § 1.861–10T(c), and in the apportionment of other expenses under the consolidation rules set forth in § 1.861–14T.

(iii) *Income that is not considered tax exempt.* The following items are not considered to be exempt, eliminated, or excluded income and, thus, may have expenses, losses, or other deductions allocated and apportioned to them:

(A) In the case of a foreign taxpayer (including a foreign sales corporation (FSC)) computing its effectively connected income, gross income (whether domestic or foreign source) which is

not effectively connected to the conduct of a United States trade or business;

(B) In computing the combined taxable income of a DISC or FSC and its related supplier, the gross income of a DISC or a FSC;

(C) For all purposes under subchapter N of the Code, including the computation of combined taxable income of a possessions corporation and its affiliates under section 936(h), the gross income of a possessions corporation for which a credit is allowed under section 936(a); and

(D) Foreign earned income as defined in section 911 and the regulations thereunder (however, the rules of §1.911–6 do not require the allocation and apportionment of certain deductions, including home mortgage interest, to foreign earned income for purposes of determining the deductions disallowed under section 911(d)(6)).

(iv) *Prior years*. For expense allocation and apportionment rules applicable to taxable years beginning before January 1, 1987, and for later years to the extent permitted by §1.861–13T, see §1.861–8(d)(2) (Revised as of April 1, 1986).

(e) *Allocation and apportionment of certain deductions*. (1) [Reserved]. For further guidance, see §1.861–8(e)(1).

(2) *Interest*. The rules concerning the allocation and apportionment of interest expense and certain interest equivalents are set forth in §§1.861–9T through §1.861–13T.

(3) through (f)(1)(i) [Reserved] For further guidance, *see* §1.861–8(e)(3) through (f)(1)(i).

(ii) *Separate limitations to the foreign tax credit*. Section 904(d)(1) requires that the foreign tax credit limitation be determined separately in the case of the types of income specified therein. Accordingly, the income within each separate limitation category constitutes a statutory grouping of income and all other income not within that separate limitation category (whether domestic or within a different separate limitation category) constitutes the residual groups.

(f)(1)(iii) through (g) *Examples 1 through 23* [Reserved] For further guidance, *see* §1.861–8(f)(1)(iii) through (g) *Examples 1 through 23*.

Example 24. Exempt, excluded, or eliminated income. (i) *Income method*—(A) *Facts*. X, a domestic corporation organized on January 1, 1987, is engaged in a number of businesses worldwide. X owns a 25-percent voting interest in each of five corporations engaged in the business A, two of which are domestic and three of which are foreign. X incurs stewardship expenses in connection with these five stock investments in the amount of $100. X apportions its stewardship expenses using a gross income method. Each of the five companies pays a dividend in the amount of $100. X is entitled to claim the 80-percent dividends received deduction on dividends paid by the two domestic companies. Because tax exempt income is considered in the allocation of deductions, X's $100 stewardship expense is allocated to the class of income consisting of dividends from business A companies. However, because tax exempt income is not considered in the apportionment of deductions within a class of gross income, the gross income of the two domestic companies must be reduced to reflect the availability of the dividends received deduction. Thus, for purposes of apportionment, the gross income paid by the three foreign companies is considered to be $100 each, while the gross income paid by the domestic companies is considered to be $20 each. Accordingly, X has total gross income from business A companies, for purposes of apportionment, of $340. As a result, $29.41 of X's stewardship expense is apportioned to each of the foreign companies and $5.88 of X's stewardship expense is apportioned to each of the domestic companies.

(ii) *Asset method*—(A) *Facts*. X, a domestic corporation organized on January 1, 1987, carries on a trade or business in the United States. X has deductible interest expense incurred in 1987 of $60,000. X owns all the stock of Y, a foreign corporation. X also owns 49 percent of the voting stock of Z, a domestic corporation. Neither Y nor Z has retained earnings and profits at the end of 1987. X apportions its interest expense on the basis of the fair market value of its assets. X has assets worth $1,500,000 that generate domestic source income, among which are tax exempt municipal bonds worth $100,000, and the stock of Z, which has a value of $500,000. The Y stock owned by X has a fair market value of $2,000,000 and generates solely foreign source general limitation income.

(B) *Allocation*. No portion of X's interest expense is directly allocable solely to identified property within the meaning of §1.861–10T. Thus, X's deduction for interest is definitely related to all its gross income as a class.

(C) *Apportionment*. For purposes of apportioning expenses, assets that generate exempt, eliminated, or excluded income are not taken into account. Because X's municipal bonds are tax exempt, they are not

taken into account in apportioning interest expense. Since X is entitled to claim under section 243 to 80-percent dividends received deduction with respect to the dividend it received from Z, 80 percent of the value of that stock is not taken into account as an asset for purposes of apportionment under the asset method. X apportions its interest deduction between the statutory grouping of foreign source general limitation income and the residual grouping of domestic source income as follows:

To foreign source general limitation income:

$$\text{Interest expense} \times \frac{\text{General limitation assets that are not tax exempt}}{\text{Worldwide assets that are not tax exempt}}$$

$$\$60{,}000 \times \frac{\$2{,}000{,}000}{(\$100{,}000 + \$900{,}000 + \$2{,}000{,}000)} = \$40{,}000$$

$$\frac{\text{Nonexempt foreign assets}}{\text{20 percent of Z stock value} + \text{Nonexempt domestic assets} + \text{Nonexempt foreign assets}}$$

To domestic source income:

$$\text{Interest expense} \times \frac{\text{Domestic assets that are not tax exempt}}{\text{Worldwide assets that are not tax exempt}}$$

$$\$60{,}000 \times \frac{\$100{,}000 + \$900{,}000}{(\$100{,}000 + \$900{,}000 + \$2{,}000{,}000)} = \$20{,}000$$

$$\frac{\text{20 percent of Z stock value} + \text{nonexempt domestic assets}}{\text{20 percent of Z stock value} + \text{Nonexempt domestic assets} + \text{Nonexempt foreign assets}}$$

Examples 25–29. [Reserved]

Example 30. [Reserved] For further guidance, *see* §1.861–8(g) *Example 30*.

(h) *Effective/applicability date*. (1) Paragraphs (f)(1)(vi)(E), (f)(1)(vi)(F), and (f)(1)(vi)(G) of this section apply to taxable years ending after April 9, 2008.

(2) Paragraph (e)(4), the last sentence of paragraph (f)(4)(i), and paragraph (g), *Examples 17*, *18*, and *30* of this section apply to taxable years beginning after July 31, 2009.

(3) Also, *see* paragraph (e)(12)(iv) of this section and 1.861–14(e)(6) for rules concerning the allocation and apportionment of deductions for charitable contributions.

[T.D. 8228, 53 FR 35474, Sept. 14, 1988]

EDITORIAL NOTES: 1. For FEDERAL REGISTER citations affecting §1.861–8T, see the List of CFR Sections Affected, which appears in the Finding Aids section of the printed volume and at *www.fdsys.gov*.

2. At 71 FR 76903, Dec. 22, 2006, in §1.861–8T, paragraph (g), paragraph (i) following *Example 30*. (i)(C) was redesignated as paragraph (ii) and the paragraph designation for *Example 30*. (i)(C) was removed; however, because of the inaccurate amendatory language, the amendment could not be incorporated..

§ 1.861–9 Allocation and apportionment of interest expense.

(a) through (e)(1) [Reserved]. For further guidance, see §1.861–9T(a) through (e)(1).

(2) *Corporate partners whose interest in the partnership is 10 percent or more*. A corporate partner shall apportion its interest expense, including the partner's distributive share of partnership interest expense, by reference to the partner's assets, including the partner's pro rata share of partnership assets, under the rules of paragraph (f) of this section if the corporate partner's

direct and indirect interest in the partnership (as determined under the attribution rules of section 318) is 10 percent or more. A corporation using the tax book value method or alternative tax book value method of apportionment shall use the partnership's inside basis in its assets, including adjustments under sections 734(b) and 743(b), if any, and adjusted to the extent required under §1.861–10T(d)(2). A corporation using the fair market value method of apportionment shall use the fair market value of the partnership's assets, adjusted to the extent required under §1.861–10T(d)(2).

(3) *Individual partners who are general partners or who are limited partners with an interest in the partnership of 10 percent or more.* An individual partner is subject to the rules of this paragraph (e)(3) if either the individual is a general partner or the individual's direct and indirect interest (as determined under the attribution rules of section 318) in the partnership is 10 percent or more. The individual shall first classify his or her distributive share of partnership interest expense as interest incurred in the active conduct of a trade or business, as passive activity interest, or as investment interest under regulations issued under sections 163 and 469. The individual must then apportion his or her interest expense, including the partner's distributive share of partnership interest expense, under the rules of paragraph (d) of this section. Each such individual partner shall take into account his or her distributive share of the partnership gross income or pro rata share of the partnership assets in applying such rules. An individual using the tax book value or alternative tax book value method of apportionment shall use the partnership's inside basis in its assets, including adjustments under sections 734(b) and 743(b), if any, and adjusted to the extent required under §1.861–10T(d)(2). An individual using the fair market value method of apportionment shall use the fair market value of the partnership's assets, adjusted to the extent required under §1.861–10(d)(2).

(e)(4) through (f)(3)(i) [Reserved]. For further guidance, see §1.861–9T(e)(4) through (f)(3)(i).

(f)(3)(ii) *Manner of election.* The election shall be made by filing the statement and providing the written notice described in §1.964–1(c)(3)(ii) and (iii), respectively, at the time and in the manner described therein. For further guidance, *see* §1.861–9T(f)(3)(ii).

(f)(3)(iii) and (iv) [Reserved] For further guidance, *see* §1.861–9T(f)(3)(iii) and (iv).

(4) *Noncontrolled section 902 corporations*—(i) *In general.* For purposes of computing earnings and profits of a noncontrolled section 902 corporation (as defined in section 904(d)(2)(E)) for Federal tax purposes, the interest expense of a noncontrolled section 902 corporation may be apportioned using either the asset method described in §1.861–9T(g) or the modified gross income method described in §1.861–9T(j). A noncontrolled section 902 corporation that is not a controlled foreign corporation may elect to use a different method of apportionment than that elected by one or more of its shareholders. A noncontrolled section 902 corporation must use the same method of apportionment with respect to all its domestic corporate shareholders.

(ii) *Manner of election.* The election to use the asset method described in §1.861–9T(g) or the modified gross income method described in §1.861–9T(j) may be made either by the noncontrolled section 902 corporation or by the majority domestic corporate shareholders (as defined in §1.964–1(c)(5)(ii)) on behalf of the noncontrolled section 902 corporation. The election shall be made by filing the statement and providing the written notice described in §1.964–1(c)(3)(ii) and (iii), respectively, at the time and in the manner described therein. For further guidance, *see* §1.861–9T(f)(4)(ii).

(iii) *Stock characterization.* In general, the stock of a noncontrolled section 902 corporation shall be characterized in the hands of any domestic corporation that meets the ownership requirements of section 902(a) with respect to the noncontrolled section 902 corporation, or in the hands of any member of the same qualified group as defined in section 902(b)(2), using the same method that the noncontrolled section 902 corporation uses to apportion its interest

expense. Stock in a noncontrolled section 902 corporation shall be characterized as a passive category asset in the hands of any such shareholder that fails to meet the substantiation requirements of § 1.904–5(c)(4)(iii), or in the hands of any shareholder that is not eligible to compute an amount of foreign taxes deemed paid with respect to a dividend from the noncontrolled section 902 corporation for the taxable year. *See* § 1.861–12(c)(4).

(f)(5) through (h)(3) [Reserved]. For further guidance, see § 1.861–9T(f)(5) through (h)(3).

(h)(4) *Valuing related party debt and stock in related persons*—(i) *Related party debt*. For purposes of this section, the value of a debt obligation of a related person held by the taxpayer or another person related to the taxpayer equals the amount of the liability of the obligor related person.

(ii) *Stock in related persons*. The value of stock in a related person held by the taxpayer or by another person related to the taxpayer equals the sum of the following amounts reduced by the taxpayer's pro rata share of liabilities of such related person:

(A) The portion of the value of intangible assets of the taxpayer and related persons that is apportioned to such related person under § 1.861–9T(h)(2);

(B) The taxpayer's pro rata share of tangible assets held by the related person (as determined under § 1.861–9T(h)(1)(ii));

(C) The taxpayer's pro rata share of debt obligations of any related person held by the related person (as valued under paragraph (h)(4)(i) of this section); and

(D) The total value of stock in all related persons held by the related person as determined under this paragraph (h)(4).

(iii) *Example*—(A) *Facts*. USP, a domestic corporation, wholly owns CFC1 and owns 80% of CFC2, both foreign corporations. The aggregate trading value of USP's stock traded on established securities markets at the end of Year 1 is $700 and the amount of USP's liabilities to unrelated persons at the end of Year 1 is $400. Neither CFC1 nor CFC2 has liabilities to unrelated persons at the end of Year 1. USP owns plant and equipment valued at $500, CFC1 owns plant and equipmen t valued at $400, and CFC2 owns plant and equipment valued at $250. The value of these assets has been determined using generally accepted valuation techniques, as required by § 1.861–9T(h)(1)(ii). There is an outstanding loan from CFC2 to CFC1 in an amount of $100. There is also an outstanding loan from USP to CFC1 in an amount of $200.

(B) *Valuation of group assets*. Pursuant to § 1.861–9T(h)(1)(i), the aggregate value of USP's assets is $1100 (the $700 trading value of USP's stock increased by $400 of USP's liabilities to unrelated persons).

(C) *Valuation of tangible assets*. Pursuant to § 1.861–9T(h)(1)(ii), the value of USP's tangible assets and pro rata share of assets held by CFC1 and CFC2 is $1100 (the plant and equipment held directly by USP, valued at $500, plus USP's 100% pro rata share of the plant and equipment held by CFC1 valued at $400 and USP's 80% pro rata share of the plant and equipment held by CFC 2 valued at $200 (80% of $250)).

(D) *Computation of intangible asset value*. Pursuant to § 1.861–9T(h)(1)(iii), the value of the intangible assets of USP, CFC1, and CFC2 is $0 (total aggregate group asset value ($1100) determined in paragraph (B) less total tangible asset value ($1100) determined in paragraph (C)). Because the intangible asset value is zero, the provisions of § 1.861–9T(h)(2) and (3) relating to the apportionment and characterization of intangible assets do not apply.

(E) *Valuing related party debt obligations*. Pursuant to § 1.861–9(h)(4)(i), the value of the debt obligation of CFC1 held by CFC2 is equal to the amount of the liability, $100. The value of the debt obligation of CFC1 held by USP is equal to the amount of the liability, $200.

(F) *Valuing the stock of CFC1 and CFC2*. Pursuant to § 1.861–9(h)(4)(ii), the value of the stock of CFC2 held by USP is $280 (USP's 80% pro rata share of tangible assets of CFC2 included in paragraph (C) ($200) plus USP's 80% pro rata share of the debt obligation of CFC1 held by CFC2 valued in paragraph (E) ($80). The value of the stock of CFC1 held by USP is $100 (USP's 100% pro rata share of tangible assets of

CFC1 included in paragraph (C) ($400) less USP's 100% pro rata share of the liabilities of CFC1 to USP and CFC2 ($300)).

(h)(5) *Characterizing stock in related persons*—(i) *General rule*. Stock in a related person held by the taxpayer or by another related person shall be characterized on the basis of the fair market value of the taxpayer's pro rata share of assets held by the related person attributed to each statutory grouping and the residual grouping under the stock characterization rules of § 1.861–12T(c)(3)(ii), except that the portion of the value of intangible assets of the taxpayer and related persons that is apportioned to the related person under § 1.861–9T(h)(2) shall be characterized on the basis of the net income before interest expense of the related person within each statutory grouping or residual grouping (excluding income that is passive under § 1.904–4(b)).

(ii) *Special rule for section 936 corporations regarding alternative minimum tax*. For purposes of characterizing stock in a related section 936 corporation in determining foreign source alternative minimum taxable income within each separate category and the alternative minimum tax foreign tax credit pursuant to section 59(a), the rules of § 1.861–9T(g)(3) shall apply and § 1.861–9(h)(5)(i) shall not apply. Thus, for taxable years beginning after December 31, 1989, and before January 1, 1994, stock in a related section 936 corporation is characterized for alternative minimum tax purposes as a foreign source passive asset because the stock produces foreign source passive dividend income under sections 861(a)(2)(A), 862(a)(2), and 904(d)(2)(A) and the regulations under those sections. For taxable years beginning after December 31, 1993, stock in a related section 936 corporation would be characterized for alternative minimum tax purposes as an asset subject to the separate limitation for section 936 corporation dividends because the stock produces foreign source dividend income that, for alternative minimum tax purposes, is subject to a separate foreign tax credit limitation under section 56(g)(4)(C)(iii)(IV). However, stock in a section 936 corporation is characterized as a U.S. source asset to the extent required by section 904(g). For the definition of the term *section 936 corporation*, see § 1.861–11(d)(2)(ii).

(6) [Reserved]. For further guidance, see § 1.861–9T(h)(6).

(i) *Alternative tax book value method*—(1) *Alternative value for certain tangible property*. A taxpayer may elect to determine the tax book value of its tangible property that is depreciated under section 168 (section 168 property) using the rules provided in this paragraph (i)(1) (the alternative tax book value method). The alternative tax book value method applies solely for purposes of apportioning expenses (including the calculation of the alternative minimum tax foreign tax credit pursuant to section 59(a)) under the asset method described in paragraph (g) of this section.

(i) The tax book value of section 168 property placed in service during or after the first taxable year to which the election to use the alternative tax book value method applies shall be determined as though such property were subject to the alternative depreciation system set forth in section 168(g) (or a successor provision) for the entire period that such property has been in service.

(ii) In the case of section 168 property placed in service prior to the first taxable year to which the election to use the alternative tax book value method applies, the tax book value of such property shall be determined under the depreciation method, convention, and recovery period provided for under section 168(g) for the first taxable year to which the election applies.

(iii) If a taxpayer revokes an election to use the alternative tax book value method (the prior election) and later makes another election to use the alternative tax book value method (the subsequent election) that is effective for a taxable year that begins within 3 years of the end of the last taxable year to which the prior election applied, the taxpayer shall determine the tax book value of its section 168 property as though the prior election has remained in effect.

(iv) The tax book value of section 168 property shall be determined without

regard to the election to expense certain depreciable assets under section 179.

(v) *Examples.* The provisions of this paragraph (i)(1) are illustrated in the following examples:

Example 1. In 2000, a taxpayer purchases and places in service section 168 property used solely in the United States. In 2005, the taxpayer elects to use the alternative tax book value method, effective for the current taxable year. For purposes of determining the tax book value of its section 168 property, the taxpayer's depreciation deduction is determined by applying the method, convention, and recovery period rules of the alternative depreciation system under section 168(g)(2) as in effect in 2005 to the taxpayer's original cost basis in such property. In 2006, the taxpayer acquires and places in service in the United States new section 168 property. The tax book value of this section 168 property is determined under the rules of section 168(g)(2) applicable to property placed in service in 2006.

Example 2. Assume the same facts as in *Example 1*, except that the taxpayer revokes the alternative tax book value method election effective for taxable year 2010. Additionally, in 2011, the taxpayer acquires new section 168 property and places it in service in the United States. If the taxpayer elects to use the alternative tax book value method effective for taxable year 2012, the taxpayer must determine the tax book value of its section 168 property as though the prior election still applied. Thus, the tax book value of property placed in service prior to 2005 would be determined by applying the method, convention, and recovery period rules of the alternative depreciation system under section 168(g)(2) applicable to property placed in service in 2005. The tax book value of section 168 property placed in service during any taxable year after 2004 would be determined by applying the method, convention, and recovery period rules of the alternative depreciation system under section 168(g)(2) applicable to property placed in service in such taxable year.

(2) *Timing and scope of election.* (i) Except as provided in this paragraph (i)(2), a taxpayer may elect to use the alternative tax book value method with respect to any taxable year beginning on or after March 26, 2004. However, pursuant to § 1.861–8T(c)(2), a taxpayer that has elected the fair market value method must obtain the consent of the Commissioner prior to electing the alternative tax book value method. Any election made pursuant to this paragraph (i)(2) shall apply to all members of an affiliated group of corporations as defined in §§ 1.861–11(d) and 1.861–11T(d). Any election made pursuant to this paragraph (i)(2) shall apply to all subsequent taxable years of the taxpayer unless revoked by the taxpayer. Revocation of such an election, other than in conjunction with an election to use the fair market value method, for a taxable year prior to the sixth taxable year for which the election applies requires the consent of the Commissioner.

(ii) *Example.* The provisions of this paragraph (i)(2) are illustrated in the following example:

Example. Corporation X, a calendar year taxpayer, elects on its original, timely filed tax return for the taxable year ending December 31, 2007, to use the alternative tax book value method for its 2007 year. The alternative tax book value method applies to Corporation X's 2007 year and all subsequent taxable years. Corporation X may not, without the consent of the Commissioner, revoke its election and determine tax book value using a method other than the alternative tax book value method with respect to any taxable year beginning before January 1, 2012. However, Corporation X may automatically elect to change from the alternative tax book value method to the fair market value method for any open year.

(3) *Certain other adjustments.* [Reserved]

(j) [Reserved]. For further guidance, see § 1.861–9T(j).

(k) *Effective/applicability date.* Paragraph (h)(5) of this section applies to taxable years beginning after December 31, 1989. Paragraph (i) of this section applies to taxable years beginning on or after March 26, 2004. Paragraphs (f)(3)(ii) and (4) of this section apply to taxable years of shareholders ending on or after April 20, 2009. See 26 CFR 1.861–9T(f)(3)(ii)(last sentence) and (4) (revised as of April 1, 2009) for rules applicable to taxable years of shareholders ending after the first day of the first taxable year of the noncontrolled section 902 corporation beginning after December 31, 2002, and ending before April 20, 2009. Paragraphs (e)(2), (e)(3) and (h)(4) apply to taxable years beginning on or after *July 16, 2014*. See 26 CFR 1.861–9T(e)(2) and (3) (revised as of April 1, 2014) for rules applicable to taxable years beginning after January 17, 2012, and before *July 16, 2014*. See 26

CFR 1.861–9T(e)(2) and (3) (revised as of April 1, 2011) for rules applicable to taxable years beginning on or before January 17, 2012. See 26 CFR 1.861–9T(h)(4) (revised as of April 1, 2014) for rules applicable to taxable years ending on or after January 17, 2012, and beginning before *July 16, 2014*. See 26 CFR 1.861–9T(h)(4) (revised as of April 1, 2011) for rules applicable to taxable years ending before January 17, 2012.

[T.D. 8916, 66 FR 272, Jan. 3, 2001, as amended by T.D. 9120, 69 FR 15675, Mar. 26, 2004; T.D. 9247, 71 FR 4814, Jan. 30, 2006; T.D. 9452, 74 FR 27873, June 11, 2009; T.D. 9456, 74 FR 46346, Sept. 9, 2009; T.D. 9676, 79 FR 41425, July 16, 2014; T.D. 9676, 79 FR 49683, Aug. 22, 2014]

§ 1.861–9T Allocation and apportionment of interest expense (temporary).

(a) *In general*. Any expense that is deductible under section 163 (including original issue discount) constitutes interest expense for purposes of this section, as well as for purposes of §§ 1.861–10T, 1.861–11T, 1.861–12T, and 1.861–13T. The term interest refers to the gross amount of interest expense incurred by a taxpayer in a given tax year. The method of allocation and apportionment for interest set forth in this section is based on the approach that, in general, money is fungible and that interest expense is attributable to all activities and property regardless of any specific purpose for incurring an obligation on which interest is paid. Exceptions to the fungibility rule are set forth in § 1.861–10T. The fungibility approach recognizes that all activities and property require funds and that management has a great deal of flexibility as to the source and use of funds. When borrowing will generally free other funds for other purposes, and it is reasonable under this approach to attribute part of the cost of borrowing to such other purposes. Consistent with the principles of fungibility, except as otherwise provided, the aggregate of deductions for interest in all cases shall be considered related to all income producing activities and assets of the taxpayer and, thus, allocable to all the gross income which the assets of the taxpayer generate, have generated, or could reasonably have been expected to generate. In the case of the interest expense of members of an affiliated group, interest expense shall be considered to be allocable to all gross income of the members of the group under § 1.861–11T. That section requires the members of an affiliated group to allocate and apportion the interest expense of each member of the group as if all members of such group were a single corporation. For the method of determining the interest deduction allowed to foreign corporations under section 882(c), see § 1.882–5.

(b) *Interest equivalents*—(1) *Certain expenses and losses*—(i) *General rule*. Any expense or loss (to the extent deductible) incurred in a transaction or series of integrated or related transactions in which the taxpayer secures the use of funds for a period of time shall be subject to allocation and apportionment under the rules of this section if such expense or loss is substantially incurred in consideration of the time value of money. However, the allocation and apportionment of a loss under this paragraph (b) shall not affect the characterization of such loss as capital or ordinary for other purposes of the Code and the regulations thereunder.

(ii) Examples. The rule of this paragraph (b)(1) may be illustrated by the following examples.

Example 1. W, a domestic corporation, borrows from X two ounces of gold at a time when the spot price for gold is $500 per ounce. W agrees to return the two ounces of gold in six months. W sells the two ounces of gold to Y for $1000. W then enters into a contract with Z to purchase two ounces of gold six months in the future for $1,050. In exchange for the use of $1,000 in cash, W has sustained a loss of $50 on related transactions. This loss is subject to allocation and apportionment under the rules of this section in the same manner as interest expense.

Example 2. X, a domestic corporation with a dollar functional currency, borrows 100 pounds on January 1, 1987 for a three-year term at an interest rate greater than the applicable federal rate for dollar loans. At this time, the interest rate on the pound was approximately equal to the interest rate on dollar borrowings and the forward price on the pound, vis-a-vis the dollar, was approximately equal to the spot price. On January 1, 1987, X converted 100 pounds into dollars and entered into a currency swap that substantially hedged X's foreign currency exposure on the pound borrowing, both with respect to

interest and principal. The borrowing, coupled with the swap, represents a series of related transactions in which the taxpayer secures the use of funds in its functional currency. Any net foreign currency loss on this series of transactions constitutes a loss incurred substantially in consideration of the time value of money and shall be apportioned in the same manner as interest expense. Thus, if the pound depreciates against the dollar, such that when the first payment on the pound borrowing is due the taxpayer has a currency loss on the swap payment hedging its first interest payment, such loss shall, even if the transaction is not integrated under section 988(d), be allocated and apportioned in the same manner as interest expense under the authority of this paragraph (b)(1).

Example 3. On January 1, 1987, X, a domestic corporation with a dollar functional currency, enters into a dollar interest rate swap contract with Y, a domestic counterparty. Under the terms of this agreement, X agrees to pay Y floating rate interest with respect to a notional principal amount of $100 for five years. In return, Y agrees to pay X fixed rate interest at 10 percent with respect to a notional principal amount of $100 for five years. On the same day, Y prepays the fixed leg of the swap by making a lump sum payment of $37 to X. This lump sum payment represents the present value of five $10 swap payments. Because X secures the use of $37 in this transaction, any net swap expense arising from the transaction represents an expense incurred substantially in consideration of the time value of money. Assuming this lump sum payment is not otherwise characterized as a loan from Y to X, and that X must amortize the $37 lump sum payment under the principles of Notice 89–21, any net swap expense incurred by X with respect to this transaction (*i.e.*, the excess, if any, of X's annual swap payment to Y over the annual amortization of the $37 lump sum payment that is taken into income by X) represents an expense equivalent to interest expense. The result would be the same if X sold the fixed leg to a third party for $37. While this example presents the case of a lump sum payment, the rules of paragraph (b)(1) would also apply to any transaction in which the swap payments are not substantially contemporaneous if the pricing of the transaction is materially affected by the time value of money. Thus, expenses and losses will be subject to apportionment under the rules of this section to the extent that such expenses or losses were incurred in consideration of the time value of money.

(2) *Certain foreign currency borrowings*—(i) *Rule.* If a taxpayer borrows in a nonfunctional currency at a rate of interest that is less than the applicable federal rate (or its equivalent in functional currency if the functional currency is not the dollar), any swap, forward, future, option, or similar financial arrangement (or any combination thereof) entered into by the taxpayer or by a related person (as defined in §1.861–8T(c)(2)) that exists during the term of the borrowing and that substantially diminishes currency risk with respect to the borrowing or interest expense thereon will be presumed to constitute a hedge of such borrowing, unless the taxpayer can demonstrate on the basis of facts and circumstances that the two transactions are in fact unrelated. Under this presumption, the currency loss incurred on the borrowing during taxable years beginning after December 31, 1988, in connection with hedged nonfunctional currency borrowings, reduced or increased by the gain or loss on the hedge, will be apportioned in the same manner as interest expense. This presumption can be rebutted by a showing that the financial arrangement was entered into in connection with hedging currency exposure arising in the ordinary course of a trade or business (other than with respect to the borrowing).

(ii) *Examples.* The principles of this paragraph (b)(2) may be illustrated by the following examples.

Example 1. Taxpayer has a dollar functional currency and does not have any qualified business units with a functional currency other than the dollar. On January 1, 1989, when the unit of foreign currency is worth $1, taxpayer borrows 100 units of foreign currency for a three-year period bearing interest at the annual rate of 3 percent and immediately converts the proceeds of the borrowing into dollars for use in its business. In the ordinary course of its business, taxpayer has no foreign currency exposure in this currency. In March 1989, taxpayer enters into a three-year swap agreement that covers most, but not all, of the payment of interest and principal. Because the swap substantially diminishes currency risk with respect to the borrowing, it is presumed to hedge the loan. Since taxpayer cannot demonstrate that it was hedging currency exposure arising in the ordinary course of its business (other than currency exposure with respect to the borrowing), the net currency loss on the borrowing adjusted for any gain or loss on the swap must be apportioned in the same manner as interest expense.

Example 2. Assume the same facts as in Example 1, except that the taxpayer borrows in

two separate foreign currencies on terms described in Example 1 and enters into a swap agreement in a single currency that substantially diminishes the taxpayer's aggregate foreign currency risk. The net currency loss on the borrowings adjusted for any gain or loss on the swap must be apportioned in the same manner as interest expense.

(3) *Losses on sale of certain receivables*—(1) *General rule.* Any loss on the sale of a trade receivable (as defined in §1.954–2(h)) shall be allocated and apportioned, solely for purposes of this section and §§1.861–10T, 1.861–11T, 1.861–12T, and 1.861–13T, in the same manner as interest expense, unless at the time of sale of the receivable, it bears interest at a rate which is at least 120 percent of the short term applicable federal rate (as determined under section 1274(d) of the Code), or its equivalent in foreign currency in the case of receivables denominated in foreign currency, determined at the time the receivable arises. This treatment shall not affect the characterization of such expense as interest for other purposes of the Internal Revenue Code.

(ii) *Exceptions.* To the extent that a loss on the sale of a trade receivable exceeds the discount on the receivable that would be computed applying to the amount received on the sale of the receivable 120 percent of the applicable federal rate (or its equivalent in foreign currency in the case of receivables denominated in foreign currency) for the period commencing with the date on which the receivable is sold and ending with the earlier of the date on which the receivable begins to bear interest at such rate or the anticipated payment date of the receivable, such excess shall not be allocated and apportioned in the same manner as interest expense but rather shall be allocated and apportioned to the gross income generated by the receivable. In cases of transfers of receivables to a domestic international sales corporation described §1.994–1(c)(6)(v), the rule of this paragraph (b)(3) shall not apply for purposes of computing combined taxable income. In computing the combined taxable income of a foreign sales corporation and its related supplier, loss on the sale of receivables to a third party incurred either by the foreign sales corporation or its related supplier shall offset combined taxable income, notwithstanding the provisions of this paragraph (b)(3). See §1.924(a)–1T(g)(7).

Example. On October 1, X sells a widget to Y for $100 payable in 30 days, after which the receivable will bear stated interest at 13 percent. On October 4, X sells Y's obligation to Z for $98. Assume that the applicable federal rate for the month of October is 10 percent. Applying 120 percent of the applicable federal rate to the $98 received on the sale of the receivable, the obligation is discounted at a 12 percent rate for a period of 27 days. At this discount rate, the obligation would have sold for $99.22. Thus, 88 cents of the $2 loss on the sale is apportioned in the same manner as interest expense, and $1.22 of the $2 loss on the sale is directly allocated to the income generated on the widget sale.

(4) *Rent in certain leasing transactions.* [Reserved]

(5) *Treatment of bond premium*—(i) *Treatment by the issuer.* If a bond or other debt obligation is issued at a premium, an amount of interest expense incurred by the issuer on that bond or other debt obligation equal to the amortized portion of that premium that is included in gross income for the year shall be allocated and apportioned solely to the amortized portion of premium derived by the issuer for the year.

(ii) *Treatment by the holder.* If a bond or debt obligation is purchased at a premium, the portion of that premium amortized during the year by the holder under section 171 and the regulations thereunder shall be allocated and apportioned solely to interest income derived from the bond by the holder for the year.

(6) *Financial products that alter effective cost of borrowing*—(i) *In general.* Various derivative financial products can be part of transactions or series of transactions described in paragraph (b)(1) of this section. Such derivative financial products, including interest rate swaps, options, forwards, caps, and collars, potentially alter a taxpayer's effective cost of borrowing with respect to an actual liability of the taxpayer. For example, a taxpayer that is obligated to pay interest at a fixed rate may, in effect, pay interest at a floating rate by entering into an interest rate swap. Similarly, a taxpayer that is obligated to pay interest at a floating rate may, in effect, limit its exposure to rising interest rates by purchasing a cap. Such a taxpayer may have gains

or losses associated with such derivative financial products. This paragraph (b)(6) provides rules for the treatment of gains and losses from such derivative financial products (''financial products'') that are part of transactions described in paragraph (b)(1) of this section and that are used by the taxpayer to alter its effective cost of borrowing with respect to an actual liability. This paragraph (b)(6) shall only apply where the hedge and the borrowing are in the same currency and shall not apply to the extent otherwise provided in section 988 and the regulations thereunder. The allocation and apportionment of a loss under this paragraph (b) shall not affect the characterization of such loss as capital or ordinary for other purposes of the Code and the regulations thereunder.

(ii) *Definition of gain and loss.* For purposes of this paragraph (b)(6), the term ''gain'' refers to the excess of the amounts properly taken into income under a financial product that alters the effective cost of borrowing over the amounts properly allowed as a deduction thereunder within a given taxable year. See. *e.g.*, Notice 89–21. The term ''loss'' refers to the excess of the amounts properly allowed as a deduction under such a financial product over the amounts properly taken into income thereunder within a given taxable year.

(iii) *Treatment of gain or loss on the disposition of a financial product.* [Reserved]

(iv) *Entities that are not financial services entities.* An entity that does not constitute a financial services entity within the meaning of §1.904–4(e)(3) shall treat gains and losses on financial products described in paragraph (b)(6)(i) of this section as follows.

(A) *Losses.* Losses on any financial product described in paragraph (b)(6)(i) of this section shall be apportioned in the same manner as interest expense whether or not such financial product is identified by the taxpayer under paragraph (b)(6)(iv)(C) of this section as a liability hedge.

(B) *Gains.* Gains on any financial product described in paragraph (b)(6)(i) of this section shall reduce the taxpayer's total interest expense that is subject to apportionment, but only if such financial product is identified by the taxpayer under paragraph (b)(6)(iv)(C) of this section as a liability hedge. Such reduction is accomplished by directly allocating interest expense to the income derived from such a financial product.

(C) *Identification of financial products.* A taxpayer can identify a financial product described in paragraph (b)(6)(i) of this section as hedging a particular interest-bearing liability (or any group of such liabilities) by clearly identifying on its books and records on the same day that it becomes a party to such arrangement that such arrangement hedges a given liability (or group of liabilities). In the case of a partial hedge, such identification shall apply to only that part of the liability that is hedged. If the taxpayer clearly identifies on its books and records a financial product as a hedge of an interest-bearing asset (or any group of such assets), it will create a rebuttable presumption that such financial product is not described in paragraph (b)(6)(i) of this section. A taxpayer may identify a hedge as relating to an anticipated liability, provided that such liability is in fact incurred within 120 days following the date of such identification. Gains and losses on such an anticipatory arrangement accruing prior to the time at which the liability is incurred shall constitute an adjustment to interest expense.

(v) *Financial services entities.* [Reserved]

(vi) *Dealers.* The rule of paragraph (b)(6)(iv) of this section shall not apply to a person acting in its capacity as a regular dealer in the financial products described in paragraph (b)(6)(i) of this section. Instead, losses sustained by a regular dealer in connection with such financial products shall be allocated to the class of gross income from such arrangements. Gains of a regular dealer in notional principal contracts are governed by the rules of §1.863–7T(b). Amounts received or accrued by any person from any financial product that is integrated as specified in Notice 89–90 with an asset shall not be treated as amounts received or accrued by a person acting in its capacity as a regular dealer in financial products.

(vii) *Examples.* The principles of this paragraph (b)(6) may be illustrated by the following examples.

Example 1. X is not a financial services entity or regular dealer in the financial products described in paragraph (b)(6)(i) of this section and has a dollar functional currency. In 1990, X incurred a total of $200 of interest expense. On January 1, 1990, X entered into an interest rate swap agreement with Y, in order to hedge its interest rate exposure with respect to a pre-existing floating rate liability. On the same day, X properly identified the agreement as a hedge of such liability. Under the agreement, X is required to pay Y an amount equal to a fixed rate of 10 percent on a notional principal amount of $1,000. Y is required to pay X an amount equal to a floating rate of interest on the same notional principal amount. Under the agreement, X received from Y during 1990 a net payment of $25. Because X identified the swap agreement as a liability hedge under the rules of paragraph (b)(6)(iv)(C), X may effectively reduce its total allocable interest expense for 1990 to $175 by directly allocating $25 of interest expense to the swap income. Had X not properly identified the swap as a liability hedge, this swap payment would have been treated as domestic source income in accordance with the rule of § 1.863–7T(b).

Example 2. Assume the same facts as Example (1), except that X did not properly identify the agreement as a liability hedge on January 1, 1990. In 1990, X made a net payment of $25 to Y under the swap agreement. This swap payment is allocated and apportioned in the same manner as interest expense under the rules of paragraph (b)(6)(iv)(A).

(7) *Foreign currency gain or loss.* In addition to the rules of paragraph (b)(1), (b)(2), and (b)(6) of this section, any foreign currency loss that is treated as an adjustment to interest expense under regulations issued under section 988 shall be allocated and apportioned in the same manner as interest expense. Any foreign currency gain that is treated as an adjustment to interest expense under regulations issued under section 988 shall offset apportionable interest expense.

(c) *Allowable deductions.* In order for an interest expense to be allocated and apportioned, it must first be determined that the interest expense is currently deductible. A number of provisions in the Code disallow or suspend deductions of interest expense or require the capitalization thereof.

(1) *Disallowed deductions.* A taxpayer does not allocate and apportion interest expense under this section that is permanently disallowed as a deduction by operation of section 163(h), section 265, or any other provision or rule that permanently disallows the deduction of interest expense.

(2) *Section 263A.* Section 263A requires the capitalization of interest expense that is allocable to designated types of property. Any interest expense that is capitalized under section 263A does not constitute deductible interest expense for purposes of this section. Furthermore, interest expense capitalized in inventory or depreciable property is not separately allocated and apportioned when the inventory is sold or depreciation is allowed. Capitalized interest expense is effectively allocated and apportioned as part of, and in the same manner as, the cost of goods sold, amortization, or depreciation deduction.

(3) *Section 163(d).* Section 163(d) suspends the deduction for interest expense to the extent that it exceeds net investment income. In the year that suspended investment interest expense becomes allowable under the rules of section 163(d), that interest expense is apportioned under rules set forth in paragraph (d)(1) of this section as though it were incurred in the taxable year in which the expense is deducted.

(4) *Section 469*—(i) *General rule.* Section 469 suspends the deduction of passive activity losses to the extent that they exceed passive activity income for the year. Passive activity losses may consist in part of interest expense properly allocable to passive activity. In the year that suspended interest expense becomes allowable as a deduction under the rules of section 469, that interest expense is apportioned under rules set forth in paragraph (d)(1) of this section as though it were incurred in the taxable year in which the expense is deducted.

(ii) *Identification of the interest component of a suspended passive loss.* A suspended passive loss may consist of a variety of items of expense other than interest expense. Suspended interest expense for any taxable year is computed by multiplying the total suspended passive loss for the year by a

fraction, the numerator of which is passive interest expense for the year (determined under regulations issued under section 163) and the denominator of which is total passive expenses for the year. The amount of the suspended interest expense that is considered to be deductible in a subsequent taxable year is computed by multiplying the amount of any cumulative suspended interest expense (reduced by suspended interest expense allowed as a deduction in prior taxable years) times a fraction, the numerator of which is the portion of cumulative suspended passive losses that become deductible in the taxable year and the denominator of which is the cumulative suspended passive losses for prior taxable years (reduced by suspended passive losses allowed as deductions in prior taxable years).

(iii) *Example*. The rules of this paragraph (c)(4) may be illustrated by the following example.

Example. On January 1, 1987, A, a United States citizen, invested in a passive activity. In 1987, the passive activity generated no passive income and $100 in passive losses, all of which were suspended by operation of section 469. The suspended loss included $10 of suspended interest expense. In 1988, the passive activity generated $50 in passive income and $150 in passive expenses which included $30 of interest expense. The entire $100 passive loss was suspended in 1988 and included $20 of interest expense ($100 suspended passive loss × $30 passive interest expense/$150 total passive expenses). Thus, at the end of 1988, A had total suspended passive losses of $200, including $30 of suspended interest expense. In 1989, the passive activity generated $100 in passive income and no passive expenses. Thus, $100 of A's cumulative suspended passive loss was therefore allowed in 1989. The $100 of deductible passive loss includes $15 of suspended interest expense ($30 cumulative suspended interest expense × $100 of cumulative suspended passive losses allowable in 1989/$200 of total cumulative suspended passive losses). The $15 of interest expense is apportioned under the rules of paragraph (d) of this section as though it were incurred in 1989.

(d) *Apportionment rules for individuals, estates, and certain trusts*—(1) *United States individuals*. In the case of taxable years beginning after December 31, 1986, individuals generally shall apportion interest expense under different rules according to the type of interest expense incurred. The interest expense of individuals shall be characterized under the regulations issued under section 163. However, in the case of an individual whose foreign source income (including income that is excluded under section 911) does not exceed a gross amount of $5,000, the apportionment of interest expense under this section is not required. Such an individual's interest expense may be allocated entirely to domestic source income.

(i) *Interest incurred in the conduct of a trade or business*. An individual who incurs business interest described in section 163(h)(2)(A) shall apportion such interest expense using an asset method by reference to the individual's business assets.

(ii) *Investment interest*. An individual who incurs investment interest described in section 163(h)(2)(B) shall apportion that interest expense on the basis of the individual's investment assets.

(iii) *Interest incurred in a passive activity*. An individual who incurs passive activity interest described in section 163(h)(2)(C) shall apportion that interest expense on the basis of the individual's passive activity assets. Individuals who receive a distributive share of interest expense incurred in a partnership are subject to special rules set forth in paragraph (e) of this section.

(iv) *Qualified residence and deductible personal interest*. Individuals who incur qualified residence interest described in section 163(h)(2)(D) shall apportion that interest expense under a gross income method, taking into account all income (including business, passive activity, and investment income) but excluding income that is exempt under section 911. For purposes of this section, any qualified residence that is rented shall be considered to be a business asset for the period in which it is rented, with the result that the interest on such a residence is not apportioned under this subdivision (iv) but instead under subdivisions (i) or (iii) of this paragraph (d)(1). To the extent that personal interest described in section 163(h)(2) remains deductible under transitional rules, individuals shall apportion such interest expense in the same manner as qualified residence interest.

(v) *Example*. The following example illustrates the principles of this section.

Example. (i) *Facts*. A is a resident individual taxpayer engaged in the active conduct of a trade or business, which A operates as a sole proprietor. A's business generates only domestic source income. A's investment portfolio consists of several less than 10 percent stock investments. Certain stocks in which A's adjusted basis is $40,000 generate domestic source income and other stocks in which A's adjusted basis is $60,000 generate foreign source passive income. In addition, A owns his personal residence, which is subject to a mortgage in the amount of $100,000. All interest expense incurred with respect to A's mortgage is qualified residence interest for purposes of section 163(h)(2)(D). A's other indebtedness consists of a bank loan in the amount of $40,000. Under the regulations issued under section 163(h), it is determined that the proceeds of the $40,000 loan were divided equally between A's business and his investment portfolio. In 1987, the gross income of A's business, before the apportionment of interest expense, was $50,000. A's investment portfolio generated $4,000 in domestic source income and $6,000 in foreign source passive income. All of A's debt obligations bear interest at the annual rate of 10 percent.

(ii) *Analysis of business interest*. Under section 163(h) of the Code, $2,000 of A's interest expense is attributable to his business. Under the rules of paragraph (d)(1)(i), such interest must be apportioned on the basis of the business assets. Applying the asset method described in paragraph (g) of this section, it is determined that all of A's business assets generate domestic income and, therefore, constitute domestic assets. Thus, the $2,000 in interest expense on the business loan is allocable to domestic source income.

(iii) *Analysis of investment interest*. Under section 163(h) of the Code, $2,000 of A's interest expense is investment interest. Under the rules of paragraph (d)(1)(ii) of this section, such interest must be apportioned on the basis of investment assets. Applying the asset method, A's investment assets consist of stock generating domestic source income with an adjusted basis of $40,000 and stock generating foreign source passive income with an adjusted basis of $60,000. Thus, 40 percent ($800) of A's investment interest is apportioned to domestic source income and 60 percent ($1,200) of A's investment interest is apportioned to foreign source passive income for purposes of section 904.

(iv) *Analysis of qualified residence interest*. The $10,000 of qualified residence interest expense is apportioned under the rules of paragraph (d)(1)(iv) of this section on the basis of all of A's gross income. A's gross income consists of $60,000, $54,000 of which is domestic source and $6,000 of which is foreign source passive income. Thus, $9,000 of A's qualified residence interest is apportioned to domestic source income and $1,000 of A's qualified residence interest is apportioned to foreign source passive income.

(2) *Nonresident aliens*—(i) *General rule*. For taxable years beginning on or after January 1, 1988, interest expense incurred by a nonresident alien shall be considered to be connected with income effectively connected with a United States trade or business only to the extent that interest expense is incurred with respect to liabilities that—

(A) Are entered on the books and records of the United States trade or business when incurred, or

(B) Are secured by assets that generate such effectively connected income.

(ii) *Limitations*—(A) *Maximum debt capitalization*. Interest expense incurred by a nonresident alien is not considered to be connected with effectively connected income to the extent that it is incurred with respect to liabilities that exceed 80 percent of the gross assets of the United States trade or business.

(B) *Collateralization by other assets*. Interest expense on indebtedness that is secured by specific assets (not including the general credit of the nonresident alien) other than the assets of the United States trade or business shall not be considered to be connected with effectively connected income.

(3) *Estates and trusts*. Estates shall be treated in the same manner as individuals. In the case of a trust that is beneficially owned by individuals and is a complex trust, the trust shall be treated in the same manner as individuals under the rules of paragraph (d) of this section, except that no de minimis amount shall apply. In the case of a trust that is beneficially owned by one or more corporations, the trust shall be treated either as a partnership or as a corporation depending on how the trust is characterized under the rules of section 7701 and the regulations thereunder.

(e) *Partnerships*—(1) *In general—aggregate rule*. A partner's distributive share of the interest expense of a partnership that is directly allocable under § 1.861–

10T to income from specific partnership property shall be treated as directly allocable to the income generated by such partnership property. Subject to the exceptions set forth in paragraph (e)(4), a partner's distributive share of the interest expense of a partnership that is not directly allocable under § 1.861–10T generally is considered related to all income producing activities and assets of the partner and shall be subject to apportionment under the rules described in this paragraph. For purposes of this section, a partner's percentage interest in a partnership shall be determined by reference to the partner's interest in partnership income for the year. Similarly, a partner's pro rata share of partnership assets shall be determined by reference to the partner's interest in partnership income for the year.

(e)(2) through (e)(3) [Reserved]. For further guidance see § 1.861–9(e)(2) through (e)(3).

(4) *Less than 10 percent limited partners and less than 10 percent corporate general partners—entity rule*—(i) *Partnership interest expense*. A limited partner (whether individual or corporate) or corporate general partner whose direct and indirect interest (as determined under the attribution rules of section 318) in the partnership is less than 10 percent shall directly allocate its distributive share of partnership interest expense to its distributive share of partnership gross income. Under § 1.904–7(i)(2) of the regulations, such a partner's distributive share of foreign source income of the partnership is treated as passive income (subject to the high taxed income exception of section 904(d)(2)(F)), except in the case of high withholding tax interest or income from a partnership interest held in the ordinary course of the partner's active trade or business, as defined in § 1.904–7(i)(2). A partner's distributive share of partnership interest expense (other than partnership interest expense that is directly allocated to identified property under § 1.861–10T) shall be apportioned in accordance with the partner's relative distributive share of gross foreign source income in each limitation category and of domestic source income from the partnership. To the extent that partnership interest expense is directly allocated under § 1.861–10T, a comparable portion of the income to which such interest expense is allocated shall be disregarded in determining the partner's relative distributive share of gross foreign source income in each limitation category and domestic source income. The partner's distributive share of the interest expense of the partnership that is directly allocable under § 1.861–10T shall be allocated according to the treatment, after application of § 1.904–7(i)(2), of the partner's distributive share of the income to which the expense is allocated.

(ii) *Other interest expense of the partner*. For purposes of apportioning other interest expense of the partner on an asset basis, the partner's interest in the partnership, and not the partner's pro rata share of partnership assets, is considered to be the relevant asset. The value of this asset for apportionment purposes is either the tax book value or fair market value of the partner's partnership interest, depending on the method of apportionment used by the taxpayer. This amount of a partner's interest in the partnership is allocated among various limitation categories in the same manner as partnership interest expense (that is not directly allocable under § 1.861–10T) is apportioned in subdivision (i) of this paragraph (e)(4). If the partner uses the tax book value method of apportionment, the partner's interest in the partnership must be reduced, for this purpose, to the extent that the partner's basis consists of liabilities that are taken into account under section 752. Under either the tax book value or fair market value method of apportionment, for purposes of this section only, the value of the partner's interest in the partnership must be reduced by the principal amount of any indebtedness of the partner the interest on which is directly allocated to its partnership interest under § 1.861–10T.

(5) *Tiered partnerships*. If a partnership is a partner in another partnership, the distributive share of interest expense of a lower-tier partnership that is subject to the rules of paragraph (e)(4) shall not be reapportioned in the hands of any higher-tier partner.

However, the distributive share of interest expense of lower-tier partnership that is subject to the rules of paragraph (e) (2) or (3) shall be apportioned by the partner of the higher-tier partnership or by any higher-tier partnership to which the rules of paragraph (e)(4) apply, taking into account the partner's indirect pro rata share of the lower-tier partnership's income or assets.

(6) *Example*—(i) *Facts*. A, B, and C are partners in a limited partnership. A is a corporate general partner, owns a 5 percent interest in the partnership, and has an adjusted basis in its partnership interest, determined without regard to section 752 of the Code, of $5. A's investment in the partnership is not held in the ordinary course of the taxpayer's active trade or business, as defined in §1.904–7(i)(2). B, a corporate limited partner, owns a 70 percent interest in the partnership, and has an adjusted basis in its partnership interest, determined without regard to section 752 of the Code, of $70. C is an individual limited partner, owns a 25 percent interest in the partnership, and has an adjusted basis in the partnership interest, determined without regard to section 752 of the Code, of $25. The partners' interests in the profits and losses of the partnership conform to their respective interests. None of the interest expense incurred directly by any of the partners is directly allocable to their partnership interest under §1.861–10T. The ABC partnership's sole assets are two apartment buildings, one domestic and the other foreign. The domestic building has an adjusted inside basis of $600 and the foreign building has an adjusted inside basis of $500. Each of the buildings is subject to a nonrecourse liability in the amount of $500. The ABC partnership's total interest expense for the taxable year is $120, both nonrecourse liabilities bearing interest at the rate of 12 percent. The indebtedness on the domestic building qualifies for direct allocation under the rules of §1.861–10T. The indebtedness on the foreign building does not so qualify. The partnership incurred no foreign taxes. The partnership's gross income for the taxable year is $360, consisting of $100 in foreign source income and $260 in domestic source income. Under §1.752–1(e), the nonrecourse liabilities of the partnership are allocated among the partners according to their share of the partnership profits. Accordingly, the adjusted basis of A, B, and C in their respective partnership interests (for other than apportionment purposes) is, respectively, $55, $770, and $275.

(ii) *Determination of the amount of partnership interest expense that is subject to allocation and apportionment*. Interest on the nonrecourse loan on the domestic building is, under §1.861–10T, directly allocable to income from that investment. The interest expense is therefore directly allocable to domestic income. Interest on the nonrecourse loan on the foreign building is not directly allocable. The interest expense is therefore subject to allocation and apportionment. Thus, $60 of interest expense is directly allocable to domestic income and $60 of interest expense is subject to allocation and apportionment.

(iii) *Analysis for Partner A*. A's distributive share of the partnership's gross income is $18, which consists of $5 in foreign source income and $13 in domestic source income. A's distributive share of the ABC interest expense is $6, $3 of which is directly allocable to domestic income and $3 of which is subject to apportionment. After direct allocation of qualifying interest expense, A's distributive share of the partnership's gross income consists of $5 in foreign source income and $10 in domestic source income. Because A is a less than 10 percent corporate partner, A's distributive share of any foreign source partnership income is considered to be passive income. Accordingly, in apportioning the $3 of partnership interest expense that is subject to apportionment on a gross income method, one-third ($1) is apportioned to foreign source passive income and two-thirds ($2) is apportioned to domestic source income. In apportioning its other interest expense, A uses the tax book value method. A's adjusted basis in A's partnership interest ($55) includes A's share of the partnership's liabilities ($50), which are included in basis under section 752. For purposes of apportioning other interest expense, A's adjusted basis in the partnership

must be reduced to the extent of such liabilities. Thus, A's adjusted basis in the partnership, for purposes of apportionment, is $5. For the purpose of apportioning A's other interest expense, this $5 in basis is characterized one-third as a foreign passive asset and two-thirds as a domestic asset, which is the ratio determined in paragraph (e)(4)(i).

(iv) *Analysis for Partner B.* B's distributive share of the ABC interest expense is $84, $42 of which is directly allocable to domestic income and $42 of which is subject to apportionment. As a corporate limited partner whose interest in the partnership is 10 percent or more, B is subject to the rules of paragraph (e)(2) and paragraph (f) of this section. These rules require that a corporate partner apportion its distributive share of partnership interest expense at the partner level on the asset method described in paragraph (g) of this section by reference to its corporate assets, which include, for this purpose, 70 percent of the partnership's assets, adjusted in the manner described in §1.861–10T(e) to reflect directly allocable interest expense.

(v) *Analysis for Partner C.* C's distributive share of the ABC interest expense is $30, $15 of which is directly allocable to domestic income and $15 of which is subject to apportionment. As an individual limited partner whose interest in the partnership is 10 percent or more, C is subject to the rules of paragraph (e)(3) of this section. These rules require that an individual's share of partnership interest expense be classified under regulations issued under section 163(h) and then apportioned under the rules applicable to individuals, which are set forth in paragraph (d) of this section.

(7) *Foreign partners.* The distributive share of partnership interest expense of a nonresident alien who is a partner in a partnership shall be considered to be connected with effectively connected income based on the percentage of the assets of the partnership that generate effectively connected income. No interest expense directly incurred by the partner may be allocated and apportioned to effectively connected income derived by the partnership.

(f) *Corporations*—(1) *Domestic corporations.* Domestic corporations shall apportion interest expense using the asset method described in paragraph (g) of this section and the applicable rules of §§1.861–10T through 1.861–13T.

(2) *Foreign branches of domestic corporations.* In the application of the asset method described in paragraph (g) of this section, a domestic corporation shall—

(i) Take into account the assets of any foreign branch, translated according to the rules set forth in paragraph (g) of this section, and

(ii) Combine with its own interest expense any deductible interest expense incurred by a branch, translated according to the rules of section 987 and the regulations thereunder.

For purposes of computing currency gain or loss on any remittance from a branch or other qualified business unit (as defined in §1.989(a)–1T) under section 987, the rules of this paragraph (f) shall not apply. The branch shall compute its currency gain or loss on remittances by taking into account only its separate expenses and its separate income.

Example. (i) *Facts.* X is a domestic corporation which operates B, a branch doing business in a foreign country. In 1988, without regard to branch B, X has gross domestic source income of $1,000 and gross foreign source general limitation income of $500 and incurs $200 of interest expense. Using the tax book value method of apportionment, X, without regard to branch B, determines the value of its assets that generate domestic source income to be $6,000 and the value of its assets that generate foreign source general limitation income to be $1,000. B constitutes a qualified business unit within the meaning of section 989 with a functional currency other than the U.S. dollar and uses the profit and loss method prescribed by section 987. Applying the translation rules of section 987, B earned $500 of gross foreign general limitation income and incurred $100 of interest expense. B incurred no other expenses. For 1988, the average functional currency book value of B's assets that generate foreign general limitation income translated at the year-end rate for 1988 is $3,000.

(ii) *Computation of net income.* The combined assets of X and B for 1988 (averaged under the rules of §1.861–9T(g)(3)) consist 60 percent of assets generating domestic source income and 40 percent of assets generating foreign source general limitation income. The combined interest expense of both X and

B is $300. Thus, $180 of the combined interest expense is apportioned to domestic source income and $120 is apportioned to the foreign source income, yielding net domestic source income of $820 and net foreign source general limitation income of $880.

(iii) *Computation of currency gain or loss.* For purposes of computing currency gain or loss on branch remittances, B takes into account only its gross income and its separate expenses. In 1988, B therefore has a net amount of income in foreign currency units equal in value to $400. Gain or loss on remittances shall be computed by reference to this amount.

(3) *Controlled foreign corporations*—(i) *In general.* For purposes of computing subpart F income and computing earnings and profits for all other federal tax purposes, the interest expense of a controlled foreign corporation may be apportioned either using the asset method described in paragraph (g) of this section or using the modified gross income method described in paragraph (j) of this section, subject to the rules of subdivisions (ii) and (iii) of this paragraph (f)(2). However, the gross income method described in paragraph (j) of this section is not available to any controlled foreign corporation if a United States shareholder and the members of its affiliated group (as defined in §1.861–11T(d)) constitute controlling shareholders of such controlled foreign corporation and such affiliated group elects the fair market value method of apportionment under paragraph (g) of this section.

(ii) *Manner of election.* The election to use the asset method described in paragraph (g) of this section or the modified gross income method described in paragraph (j) of this section may be made either by the controlled foreign corporation or by the controlling United States shareholders on behalf of the controlled foreign corporation. The term ''controlling United States shareholders'' means those United States shareholders (as defined in section 951(b)) who, in aggregate, own (within the meaning of section 958(a)) greater than 50 percent of the total combined voting power of all classes of stock of the foreign corporation entitled to vote. In the case of a controlled foreign corporation in which the United States shareholders own stock representing more than 50 percent of the value of the stock in such corporation, but less than 50 percent of the combined voting power of all classes of stock in such corporation, the term ''controlling United States shareholders'' means all the United States shareholders (as defined in section 951(b)) who own (within the meaning of section 958(a)) stock of the controlled foreign corporation. All United States shareholders are bound by the election of either the controlled foreign corporation or the controlling United States shareholders. For guidance relating to the time and manner of this election, *see* §1.861–9(f)(3)(ii).

(iii) *Consistency requirement.* The same method of apportionment must be employed by all controlled foreign corporations in which a United States taxpayer and the members of its affiliated group (as defined in §1.861–11T(d)) constitute controlling United States shareholders. A controlled foreign corporation that is required by this paragraph (f)(3)(iii) to utilize a particular method of apportionment must do so with respect to all United States shareholders.

(iv) *Stock characterization.* Pursuant to §1.861–12T(c)(2), the stock of a controlled foreign corporation shall be characterized in the hands of any United States shareholder using the same method that the controlled foreign corporation uses to apportion its interest expense.

(4) *Noncontrolled section 902 corporations*—(i) *In general.* For purposes of computing earnings and profits of a noncontrolled section 902 corporation (as defined in section 904(d)(2)(E)) for federal tax purposes, the interest expense of a noncontrolled section 902 corporation may be apportioned using either the asset method described in paragraph (g) of this section or the modified gross income method described in paragraph (j) of this section. A noncontrolled section 902 corporation that is not a controlled foreign corporation may elect to use a different method of apportionment than that elected by one or more of its shareholders. For further guidance, *see* §1.861–9(f)(4).

(ii) *Manner of election.* The election to use the asset method described in paragraph (g) of this section or the modified gross income method described in

paragraph (j) of this section may be made either by the noncontrolled section 902 corporation or by the majority domestic corporate shareholders (as defined in §1.964–1T(c)(5)(ii)) on behalf of the noncontrolled section 902 corporation. The election shall be made by filing a statement described in §1.964–1T(c)(3)(ii) at the time and in the manner described therein and providing a written notice described in §1.964–1T(c)(3)(iii), except that no such statement or notice is required to be filed or sent before July 24, 2006.

(iii) *Stock characterization.* In general, the stock of a noncontrolled section 902 corporation shall be characterized in the hands of any domestic corporation that meets the ownership requirements of section 902(a) with respect to the noncontrolled section 902 corporation, or in the hands of any member of the same qualified group as defined in section 902(b)(2), using the same method that the noncontrolled section 902 corporation uses to apportion its interest expense. Stock in a noncontrolled section 902 corporation shall be characterized as a passive category asset in the hands of any such shareholder that fails to meet the substantiation requirements of §1.904–5T(c)(4)(iii), or in the hands of any shareholder that is not eligible to compute an amount of foreign taxes deemed paid with respect to a dividend from the noncontrolled section 902 corporation for the taxable year. See §1.861–12T(c)(4).

(iv) *Effective date.* This paragraph (f)(4) applies for taxable years of shareholders ending after the first day of the first taxable year of the noncontrolled section 902 corporation beginning after December 31, 2002.

(5) *Other relevant provisions.* Affiliated groups of corporations are subject to special rules set forth in §1.861–11T. Section 1.861–12T sets forth rules relating to basis adjustments for stock in nonaffiliated 10 percent owned corporations, special rules relating to the consideration and characterization of certain assets in the apportionment of interest expense, and to other special rules pertaining to the apportionment of interest expense. Section 1.861–13T contains transition rules limiting the application of the rules of §§1.861–8T through 1.861–12T, which are otherwise applicable to taxable years beginning after 1986. In the case of an affiliated group of corporations as defined in §1.861–11T(d), any reference in §§1.861–8T through 1.861–13T to the ''taxpayer'' with respect to the allocation and apportionment of interest expense generally denotes the entire affiliated group of corporations and not the separate members thereof, unless the context otherwise requires.

(g) *Asset method*—(1) *In general.* (i) Under the asset method, the taxpayer apportions interest expense to the various statutory groupings based on the average total value of assets within each such grouping for the taxable year, as determined under the asset valuation rules of this paragraph (g)(1) and paragraph (g)(2) of this section and the asset characterization rules of paragraph (g)(3) of this section and §1.861–12T. Except to the extent otherwise provided (*see, e.g.*, paragraph (d)(1)(iv) of this section), taxpayers must apportion interest expense only on the basis of asset values and may not apportion any interest deduction on the basis of gross income.

(ii) A taxpayer may elect to determine the value of its assets on the basis of either the tax book value or the fair market value of its assets. For rules concerning the application of an alternative method of valuing assets for purposes of the tax book value method, see §1.861–9(i). For rules concerning the application of the fair market value method, see paragraph (h) of this section. In the case of an affiliated group—

(A) The parent of which used the fair market value method prior to 1987, or

(B) A substantial portion of which used the fair market value method prior to 1987, such a taxpayer may use either the fair market value method or the tax book value method for its tax year commencing in 1987 and may use either such method in its tax year commencing in 1988 without regard to which method was used in its tax year commencing in 1987 and without securing the Commissioner's consent. The use of the fair market value method in 1988, however, shall operate as a binding election as described in §1.861–8T(c)(2). For rules requiring consistency in the use of the tax book value or

fair market value method, see § 1.861–8T(c)(2).

(iii) A taxpayer electing to apportion its interest expense on the basis of the fair market value of its assets must establish the fair market value to the satisfaction of the Commissioner. If a taxpayer fails to establish the fair market value of an asset to the satisfaction of the Commissioner, the Commissioner may determine the appropriate asset value. If a taxpayer fails to establish the value of a substantial portion of its assets to the satisfaction of the Commissioner, the Commissioner may require the taxpayer to use the tax book value method of apportionment.

(iv) For rules relating to earnings and profits adjustments by taxpayers using the tax book value method for the stock in certain nonaffiliated 10 percent owned corporations, see § 1.861–12T(b).

(v) The provisions of this paragraph (g)(1) may be illustrated by the following examples.

Example 1. (i) *Facts.* X, a domestic corporation organized on January 1, 1987, has deductible interest expense in 1987 in the amount of $150,000. X apportions its expenses according to the tax book value method. The adjusted basis of X's assets is $3,600,000, $3,000,000 of which generate domestic source income and $600,000 of which generate foreign source general limitation income.

(ii) *Allocation.* No portion of the $150,000 deduction is directly allocable solely to identified property within the meaning of § 1.861–10T. Thus, X's deduction for interest is related to all its activities and assets.

(iii) *Apportionment.* X apportions its interest expense as follows:

To foreign source general limitation income:

$$\$150{,}000 \times \frac{\$600{,}000}{\$3{,}600{,}000} \ldots\ldots \$25{,}000$$

To domestic source income:

$$\$150{,}000 \times \frac{\$300{,}000}{\$3{,}600{,}000} \ldots\ldots \$125{,}000$$

Example 2. (i) *Facts.* Assume the same facts as in Example 1, except that X apportions its interest expense on the basis of the fair market value of its assets. X's total assets have a fair market value of $4,000,000, $3,200,000 of which generate domestic source income and $800,000 of which generate foreign source general limitation income.

(ii) *Allocation.* No portion of the $150,000 deduction is directly allocable solely to identified property within the meaning of § 1.861–10T. Thus, X's deduction for interest is related to all its activities and properties.

(iii) *Apportionment.* If it establishes the fair market value of its assets to the satisfaction of the Commissioner, X may apportion its interest expense as follows:

To foreign source general limitation income:

$$\$150{,}000 \times \frac{\$800{,}000}{\$4{,}000{,}000} \ldots\ldots \$30{,}000$$

To domestic source income:

$$\$150{,}000 \times \frac{\$3{,}200{,}000}{\$4{,}000{,}000} \ldots\ldots \$120{,}000$$

(2) *Asset values*—(i) *General rule.* For purposes of determining the value of assets under this section, an average of values (book or market) within each statutory grouping and the residual grouping shall be computed for the year on the basis of values of assets at the beginning and end of the year. For the first taxable year beginning after 1986, a taxpayer may choose to determine asset values solely by reference to the year-end value of its assets, provided that all the members of an affiliated group as defined in § 1.861–11T(d) make the same choice. Thus, no averaging is required for the first taxable year beginning after 1986. Where a substantial distortion of asset values would result from averaging beginning-of-year and year-end values, as might be the case in the event of a major corporate acquisition or disposition, the taxpayer must use a different method of asset valuation that more clearly reflects the average value of assets weighted to reflect the time such assets are held by the taxpayer during the taxable year.

(ii) *Special rule for qualified business units of domestic corporations with functional currency other than the U.S. dollar*—(A) *Tax book value method.* In the case of taxpayers using the tax book value method of apportionment, the following rules shall apply to determine the value of the assets of a qualified business unit (as defined in section 989(a)) of a domestic corporation with a functional currency other than the dollar.

(*1*) *Profit and loss branch*. In the case of a branch for which an election is not effective under § 1.985–2T to use the dollar approximate separate transactions method of computing currency gain or loss, the tax book value shall be determined by applying the rules of paragraph (g)(2)(i) and (3) of this section with respect to beginning-of-year and end-of-year tax book value in units of functional currency that are translated into dollars at the end-of-year exchange rate between the functional currency and the U.S. dollar.

Example. At the end of 1987, a profit and loss branch has assets that generate foreign source general limitation income with a tax book value in units of functional currency of 100. At the end of 1987, the unit is worth $1. At the end of 1988, the branch has assets that generate foreign source general limitation income with a tax book value in units of functional currency of 80. At the end of 1988, the unit is worth $2. The average value of foreign source general limitation assets for 1988 is 90 units, which is worth $180.

(*2*) *Approximate separate transactions method*. In the case of a branch for which an election is effective under § 1.985–2T to use the dollar approximate separate transactions method to compute currency gain or loss, the beginning-of-year dollar amount of the assets shall be determined by reference to the end-of-year balance sheet of the branch for the immediately preceding taxable year, adjusted for United States generally accepted accounting principles and United States tax accounting principles, and translated into U.S. dollars as provided in § 1.985–3T. The year-end dollar amount of the assets of the branch shall be determined in the same manner by reference to the end-of-year balance sheet for the current taxable year. The beginning-of-year and end-of-year dollar tax book value of assets, as so determined, within each grouping must then be averaged as provided in paragraph (g)(2)(i) of this section.

(B) *Fair market value method*. In the case of taxpayers using the fair market value method of apportionment, the beginning-of-year and end-of-year fair market values of branch assets within each grouping shall be computed in dollars and averaged as provided in this paragraph (g)(2).

(iii) *Adjustment for directly allocated interest*. Prior to averaging, the year-end value of any asset to which interest expense is directly allocated during the current taxable year under the rules of § 1.861–10T (b) or (c) shall be reduced (but not below zero) by the percentage of the principal amount of indebtedness outstanding at year-end equal to the percentage of all interest on the debt for the taxable year that is directly allocated.

(iv) *Assets in intercompany transactions*. In the application of the asset method described in this paragraph (g), the tax book value of assets transferred between affiliated corporations in intercompany transactions shall be determined without regard to the gain or loss that is deferred under the regulations issued under section 1502.

(v) *Example*. X is a domestic corporation that uses the fair market value method of apportionment. X is a calendar year taxpayer. X owns 25 percent of the stock of A, a noncontrolled section 902 corporation. At the end of 1987, the fair market value of X's assets by income grouping are as follows:

Domestic	$1,000,000
Foreign general limitation	500,000
Foreign passive	500,000
Noncontrolled section 902 corporation	50,000

For its 1987 tax year, X apportions its interest expense by reference to the 1987 year-end values. In July of 1988, X sells a portion of its investment in A and in an asset acquisition purchases a shipping business, the assets of which generate exclusively foreign shipping income. At the end of 1988, the fair market values of X's assets by income grouping are as follows:

Domestic	$800,000
Foreign general limitation	900,000
Foreign passive	300,000
Noncontrolled section 902 corporation	40,000
Foreign shipping	100,000

For its 1988 tax year, X shall apportion its interest expense by reference to the average of the 1988 beginning-of-year values (the 1987 year-end values) and the 1988 year-end values, assuming that the averaging of beginning-of-year and end-of-year values does not cause a substantial distortion of asset values. These averages are as follows:

Domestic	$900,000
Foreign general limitation	700,000
Foreign passive	400,000
Foreign shipping	50,000
Noncontrolled section 902 corporation	45,000

(3) *Characterization of assets.* Assets are charactrized for purposes of this section according to the source and type of the income that they generate, have generated, or may reasonably be expected to generate. The physical location of assets is not relevant to this determination. Subject to the special rules of paragraph (h) concerning the application of the fair market value method of apportionment, the value of assets within each statutory grouping and the residual grouping at the beginning and end of each year shall be determined by dividing the taxpayer's assets into three types—

(i) *Single category assets.* Assets that generate income that is exclusively within a single statutory grouping or the residual grouping;

(ii) *Multiple category assets.* Assets that generate income within more than one grouping of income (statutory or residual); and

(iii) *Assets without directly identifiable yield.* Assets that produce no directly identifiable income yield or that contribute equally to the generation of all the income of the taxpayer (such as assets used in general and administrative functions).

Single category assets are directly attributable to the relevant statutory or residual grouping of income. In order to attribute multiple category assets to the relevant groupings of income, the income yield of each such asset for the taxable year must be analyzed to determine the proportion of gross income generated by it within each relevant grouping. The value of each asset is then prorated among the relevant groupings of income according to their respective proportions of gross income. The value of each asset without directly identifiable income yield must be identified. However, because prorating the value of such assets cannot alter the ratio of assets within the various groupings of income (as determined by reference to the single and multiple category assets), they are not taken into account in determining that ratio. Special asset characterization rules that are set forth in § 1.861–12T. An example demonstrating the application of the asset method is set forth in § 1.861–12T(d).

(h) *The fair market value method.* An affiliated group (as defined in § 1.861–11T(d)) or other taxpayer (the ''taxpayer'') that elects to use the fair market value method of apportionment shall value its assets according to the following methodology.

(1) *Determination of values*—(i) *Valuation of group assets.* The taxpayer shall first determine the aggregate value of the assets of the taxpayer on the last day of its taxable year without excluding the value of stock in foreign subsidiaries or any other asset. In the case of a publicly traded corporation, this determination shall be equal to the aggregate trading value of the taxpayer's stock traded on established securities markets at year-end increased by the taxpayer's year-end liabilities to unrelated persons and its pro rata share of year-end liabilities of all related persons owed to unrelated persons. In determining whether persons are related, § 1.861–8T(c)(2) shall apply. In the case of a corporation that is not publicly traded, this determination shall be made by reference to the capitalization of corporate earnings, in accordance with the rules of Rev. Rul. 68–609. In either case, control premium shall not be taken into account.

(ii) *Valuation of tangible assets.* The taxpayer shall determine the value of all assets held by the taxpayer and its pro rata share of assets held by other related persons on the last day of its taxable year, excluding stock or indebtedness in such persons, any intangible property as defined in section 936(h)(3)(B), or goodwill or going concern value intangibles. Such valuations shall be made using generally accepted valuation techniques. For this purpose, assets may be combined into reasonable groupings. Statistical methods of valuation may only be used in connection with fungible property, such as commodities. The value of stock in any corporation that is not a related person shall be determined under the rules of paragraph (h)(1)(i) of this section, except that no liabilities shall be taken into account.

(iii) *Computation of intangible asset value.* The value of the intangible assets of the taxpayer and of intangible assets of all related persons attributable to the taxpayer's ownership in related persons is equal to the amount obtained by subtracting the amount determined under paragraph (h)(1)(ii) of this section from the amount determined under paragraph (h)(1)(i) of this section.

(2) *Apportionment of intangible asset value.* The value of the intangible assets determined under paragraph (h)(1)(iii) of this section is apportioned among the taxpayer and all related persons in proportion to the net income before interest expense of the taxpayer and the taxpayer's pro rata share of the net income before interest expense of each ralated person held by the taxpayer, excluding income that is passive under § 1.904–4(b). For this purpose, net income is determined before reduction for income taxes. Net income of the taxpayer and of related persons shall be computed without regard to dividends or interest received from any person that is related to the taxpayer.

(3) *Characterization of affiliated group's portion of intangible asset value.* The portion of the value of intangible assets of the taxpayer and related persons that is apportioned to the taxpayer under paragraph (h)(2) of this section is characterized on the basis of net income before interest expense, as determined under paragraph (h)(2) of this section, of the taxpayer within each statutory or residual grouping of income.

(4) [Reserved]. For further guidance see § 1.861–9(h)(4).

(5) [Reserved]. For further guidance, see § 1.861–9(h)(5).

(6) *Adjustments for apportioning related person expenses.* For purposes of apportioning expenses of a related person, the value of stock in a second related person as otherwise determined under paragraph (h)(4) of this section (which is determined on the basis of the taxpayer's percentage ownership interest in the second related person) shall be increased to reflect the first related person's percentage ownership interest in the second related person to the extent it is larger.

Example. Assume that a taxpayer owns 80 percent of CFC1, which owns 100 percent of CFC2. The value of CFC1 is determined generally under paragraph (h)(4) on the basis of the taxpayer's 80 percent indirect interest in CFC2. For purposes of apportioning expenses of CFC1, 100 percent of the stock of CFC1 must be taken into account. Therefore, the value of CFC2 stock in the hands of CFC1 shall equal the value of CFC2 stock in the hands of CFC1 as determined under paragraph (h)(4) of this section, increased by 25 percent of such amount to reflect the fact that CFC1 owns 100 percent and not 80 percent of CFC2.

(i) [Reserved]. For further guidance, see § 1.861–9(i).

(j) *Modified gross income method.* Subject to rules set forth in paragraph (f)(3) of this section, the interest expense of a controlled foreign corporation may be allocated according to the following rules.

(1) *Single-tier controlled foreign corporation.* In the case of a controlled foreign corporation that does not hold stock in any lower-tier controlled foreign corporation, the interest expense of the controlled foreign corporation shall be apportioned based on its gross income.

(2) *Multiple vertically owned controlled foreign corporations.* In the case of a controlled foreign corporation that holds stock in any lower-tier controlled foreign corporation, the interest expense of that controlled foreign corporation and such upper-tier controlled foreign corporation shall be apportioned based on the following methodology:

(i) *Step 1.* Commencing with the lowest-tier controlled foreign corporation in the chain, allocate and apportion its interest expense based on its gross income as provided in paragraph (j)(1) of this section, yielding gross income in each grouping net of interest expense.

(ii) *Step 2.* Moving to the next higher-tier controlled foreign corporation, combine the gross income of such corporation within each grouping with its pro rata share of the gross income net of interest expense of all lower-tier controlled foreign corporations held by such higher-tier corporation within the same grouping adjusted as follows:

(A) Exclude from the gross income of the upper-tier corporation any dividends or other payments received from

the lower-tier corporation other than interest subject to look-through under section 904(d)(3); and

(B) Exclude from the gross income net of interest expense of any lower-tier corporation any subpart F income (net of interest expense apportioned to such income).

Then apportion the interest expense of the higher-tier controlled foreign corporation based on the adjusted combined gross income amounts. Repeat this step 2 for each next higher-tier controlled foreign corporation in the chain. For purposes of this paragraph (j)(2)(ii), pro rata share shall be determined under principles similar to section 951(a)(2).

(k) *Effective/applicability dates*. In general, the rules of this section apply for taxable years beginning after December 31, 1986. Paragraphs (b)(2) (concerning the treatment of certain foreign currency) and (d)(2) (concerning the treatment of interest incurred by nonresident aliens) of this section are applicable for taxable years commencing after December 31, 1988. Taxpayers may also apply paragraph (b)(6) of this section to any gain that was realized on any transaction described in paragraph (b)(6)(i) of this section that was entered into after September 14, 1988, and on or before August 11, 1989, if the taxpayer can demonstrate to the satisfaction of the Commissioner that substantially all of the arrangements described in paragraph (b)(6)(i) of this section to which the taxpayer became a party during that interim period were identified on the taxpayer's books and records with the liabilities of the taxpayer in a substantially contemporaneous manner and that all losses and expenses that are subject to the rules of paragraph (b)(6) of this section were treated in the same manner as interest expense. For this purpose, arrangements that were identified in a substantially contemporaneous manner with the taxpayer's assets shall be ignored. For further guidance, *see* § 1.861–9(k).

[T.D. 8228, 53 FR 35477, Sept. 14, 1988]

EDITORIAL NOTE: For FEDERAL REGISTER citations affecting § 1.861–9T, see the List of CFR Sections Affected, which appears in the Finding Aids section of the printed volume and at *www.fdsys.gov*.

§ 1.861–10 Special allocations of interest expense.

(a)–(d) [Reserved]

(e) *Treatment of certain related group indebtedness*—(1) *In general*. If, for any taxable year beginning after December 31, 1991, a U.S. shareholder (as defined in paragraph (e)(5)(i) of this section) has both—

(i) Excess related group indebtedness (as determined under Step One in paragraph (e)(2) of this section) and

(ii) Excess U.S. shareholder indebtedness (as determined under Step Two in paragraph (e)(3) of this section),

the U.S. shareholder shall allocate, to its gross income in the various separate limitation categories described in section 904(d)(1), a portion of its interest expense paid or accrued to any obligee who is not a member of the affiliated group (as defined in § 1.861–11T(d)) of the U.S. shareholder (''third party interest expense''), excluding amounts allocated under paragraphs (b) and (c) of § 1.861–10T. The amount of third party interest expense so allocated shall equal the total amount of interest income derived by the U.S. shareholder during the year from related group indebtedness, multiplied by the ratio of the lesser of the foregoing two amounts of excess indebtedness for the year to related group indebtedness for the year. This amount of third party interest expense is allocated as described in Step Three in paragraph (e)(4) of this section.

(2) *Step One: Excess related group indebtedness*. (i) The excess related group indebtedness of a U.S. shareholder for the year equals the amount by which its related group indebtedness for the year exceeds its allowable related group indebtedness for the year.

(ii) The ''related group indebtedness'' of the U.S. shareholder is the average of the aggregate amounts at the beginning and end of the year of indebtedness owed to the U.S. shareholder by each controlled foreign corporation which is a related person (as defined in paragraph (e)(5)(ii) of this section) with respect to the U.S. shareholder.

(iii) The ''allowable related group indebtedness'' of a U.S. shareholder for the year equals—

(A) The average of the aggregate values at the beginning and end of the year of the assets (including stock holdings in and obligations of related persons, other than related controlled foreign corporations) of each related controlled foreign corporation, multiplied by

(B) The foreign base period ratio of the U.S. shareholder for the year.

(iv) The ''foreign base period ratio'' of the U.S. shareholder for the year is the average of the related group debt-to-asset ratios of the U.S. shareholder for each taxable year comprising the foreign base period for the current year (each a ''base year''). For this purpose, however, the related group debt-to-asset ratio of the U.S. shareholder for any base year may not exceed 110 percent of the foreign base period ratio for that base year. This limitation shall not apply with respect to any of the five taxable years chosen as initial base years by the U.S. shareholder under paragraph (e)(2)(v) of this section or with respect to any base year for which the related group debt-to-asset ratio does not exceed 0.10.

(v)(A) The foreign base period for any current taxable year (except as described in paragraphs (e)(2)(v) (B) and (C) of this section) shall consist of the five taxable years immediately preceding the current year.

(B) The U.S. shareholder may choose as foreign base periods for all of its first five taxable years for which this paragraph (e) is effective the following alternative base periods:

(*1*) For the first effective taxable year, the 1982, 1983, 1984, 1985 and 1986 taxable years;

(*2*) For the second effective taxable year, the 1983, 1984, 1985 and 1986 taxable years and the first effective taxable year;

(*3*) For the third effective taxable year, the 1984, 1985 and 1986 taxable years and the first and second effective taxable years;

(*4*) For the fourth effective taxable year, the 1985 and 1986 taxable years and the first, second and third effective taxable years; and

(*5*) For the fifth effective taxable year, the 1986 taxable year and the first, second, third and fourth effective taxable years.

(C) If, however, the U.S. shareholder does not choose, under paragraph (e)(10)(ii) of this section, to apply this paragraph (e) to one or more taxable years beginning before January 1, 1992, the U.S. shareholder may not include within any foreign base period the taxable year immediately preceding the first effective taxable year. Thus, for example, a U.S. shareholder for which the first effective taxable year is the taxable year beginning on October 1, 1992, may not include the taxable year beginning on October 1, 1991, in any foreign base period. Assuming that the U.S. shareholder does not elect the alternative base periods described in paragraph (e)(2)(v)(B) of this section, the initial foreign base period for the U.S. shareholder will consist of the taxable years beginning on October 1 of 1986, 1987, 1988, 1989, and 1990. The foreign base period for the U.S. shareholder for the following taxable year, beginning on October 1, 1993, will consist of the taxable years beginning on October 1 of 1987, 1988, 1989, 1990, and 1992.

(D) If the U.S. shareholder chooses the base periods described in paragraph (e)(2)(v)(B) of this section as foreign base periods, it must make a similar election under paragraph (e)(3)(v)(B) of this section with respect to its U.S. base periods.

(vi) The ''related group debt-to-asset ratio'' of a U.S. shareholder for a year is the ratio between—

(A) The related group indebtedness of the U.S. shareholder for the year (as determined under paragraph (e)(2)(ii) of this section); and

(B) The average of the aggregate values at the beginning and end of the year of the assets (including stock holdings in and obligations of related persons, other than related controlled foreign corporations) of each related controlled foreign corporation.

(vii) Notwithstanding paragraph (e)(2)(i) of this section, a U.S. shareholder is considered to have no excess related group indebtedness for the year if—

(A) Its related group indebtedness for the year does not exceed its allowable related group indebtedness for the immediately preceding year (as determined under paragraph (e)(2)(iii) of this section); or

(B) Its related group debt-to-asset ratio (as determined under paragraph (e)(2)(vi) of this section) for the year does not exceed 0.10.

(3) *Step Two: Excess U.S. shareholder indebtedness.* (i) The excess indebtedness of a U.S. shareholder for the year equals the amount by which its unaffiliated indebtedness for the year exceeds its allowable indebtedness for the year.

(ii) The ''unaffiliated indebtedness'' of the U.S. shareholder is the average of the aggregate amounts at the beginning and end of the year of indebtedness owed by the U.S. shareholder to any obligee, other than a member of the affiliated group (as defined in §1.861–11T(d)) of the U.S shareholder.

(iii) The ''allowable indebtedness'' of a U.S. shareholder for the year equals—

(A) The average of the aggregate values at the beginning and end of the year of the assets of the U.S. shareholder (including stock holdings in and obligations of related controlled foreign corporations, but excluding stock holdings in and obligations of members of the affiliated group (as defined in §1.861–11T(d)) of the U.S. shareholder), reduced by the amount of the excess related group indebtedness of the U.S. shareholder for the year (as determined under Step One in paragraph (e)(2) of this section), multiplied by

(B) The U.S. base period ratio of the U.S. shareholder for the year.

(iv) The ''U.S. base period ratio'' of the U.S. shareholder for the year is the average of the debt-to-asset ratios of the U.S. shareholder for each taxable year comprising the U.S. base period for the current year (each a ''base year''). For this purpose, however, the debt-to-asset ratio of the U.S. shareholder for any base year may not exceed 110 percent of the U.S. base period ratio for that base year. This limitation shall not apply with respect to any of the five taxable years chosen as initial base years by the U.S. shareholder under paragraph (e)(3)(v) of this section or with respect to any base year for which of the debt-to-asset ratio does not exceed 0.10.

(v)(A) The U.S. base period for any current taxable year (except as described in paragraphs (e)(3)(v) (B) and (C) of this section) shall consist of the five taxable years immediately preceding the current year.

(B) The U.S. shareholder may choose as U.S. base periods for all of its first five taxable years for which this paragraph (e) is effective the following alternative base periods:

(*1*) For the first effective taxable year, the 1982, 1983, 1984, 1985 and 1986 taxable years;

(*2*) For the second effective taxable year, the 1983, 1984, 1985 and 1986 taxable years and the first effective taxable year;

(*3*) For the third effective taxable year, the 1984, 1985 and 1986 taxable years and the first and second effective taxable years;

(*4*) For the fourth effective taxable year, the 1985 and 1986 taxable years and the first, second and third effective taxable years; and

(*5*) For the fifth effective taxable year, the 1986 taxable year and the first, second, third and fourth effective taxable years.

(C) If, however, the U.S. shareholder does not choose, under paragraph (e)(10)(ii) of this section, to apply this paragraph (e) to one or more taxable years beginning before January 1, 1992, the U.S. shareholder may not include within any U.S. base period the taxable year immediately preceding the first effective taxable year. Thus, for example, a U.S. shareholder for which the first effective taxable year is the taxable year beginning on October 1, 1992, may not include the taxable year beginning on October 1, 1991, in any U.S. base period. Assuming that the U.S. shareholder does not elect the alternative base periods described in paragraph (e)(3)(v)(B) of this section, the initial U.S. base period for the U.S. shareholder will consist of the taxable years beginning on October 1, of 1986, 1987, 1988, 1989, and 1990. The U.S. base period for the U.S. shareholder for the following taxable year, beginning on October 1, 1993, will consist of the taxable years beginning on October 1, 1987, 1988, 1989, 1990, and 1992.

(D) If the U.S. shareholder chooses the base periods described in paragraph (e)(3)(v)(B) of this section as U.S. base periods, it must make a similar election under paragraph (e)(2)(v)(B) of this section with respect to its foreign base periods.

(vi) The ''debt-to-asset ratio'' of a U.S. shareholder for a year is the ratio between—

(A) The unaffiliated indebtedness of the U.S. shareholder for the year (as determined under paragraph (e)(3)(ii) of this section); and

(B) The average of the aggregate values at the beginning and end of the year of the assets of the U.S. shareholder. For this purpose, the assets of the U.S. shareholder include stock holdings in and obligations of related controlled foreign corporations but do not include stock holdings in and obligations of members of the affiliated group (as defined in §1.861–11T(d)).

(vii) A U.S. shareholder is considered to have no excess indebtedness for the year if its debt-to-asset ratio (as determined under paragraph (e)(3)(vi) of this section) for the year does not exceed 0.10.

(4) *Step Three: Allocation of third party interest expense.* (i) A U.S. shareholder shall allocate to its gross income in the various separate limitation categories described in section 904(d)(1) a portion of its third party interest expense incurred during the year equal in amount to the interest income derived by the U.S. shareholder during the year from allocable related group indebtedness.

(ii) The ''allocable related group indebtedness'' of a U.S. shareholder for any year is an amount of related group indebtedness equal to the lesser of—

(A) The excess related group indebtedness of the U.S. shareholder for the year (determined under Step One in paragraph (e)(2) of this section); or

(B) The excess U.S. shareholder indebtedness for the year (determined under Step Two in paragraph (e)(3) of this section).

(iii) The amount of interest income derived by a U.S. shareholder from allocable related group indebtedness during the year equals the total amount of interest income derived by the U.S. shareholder during the year with respect to related group indebtedness, multiplied by the ratio of allocable related group indebtedness for the year to the aggregate amount of related group indebtedness for the year.

(iv) The portion of third party interest expense described in paragraph (e)(4)(i) of this section shall be allocated in proportion to the relative average amounts of related group indebtedness held by the U.S. shareholder in each separate limitation category during the year. The remaining portion of third party interest expense of the U.S. shareholder for the year shall be apportioned as provided in §§1.861–8T through 1.861–13T, excluding paragraph (e) of §1.861–10T and this paragraph (e).

(v) The average amount of related group indebtedness held by the U.S. shareholder in each separate limitation category during the year equals the average of the aggregate amounts of such indebtedness in each separate limitation category at the beginning and end of the year. Solely for purposes of this paragraph (e)(4), each debt obligation of a related controlled foreign corporation held by the U.S. shareholder at the beginning or end of the year is attributed to separate limitation categories in the same manner as the stock of the obligor would be attributed under the rules of §1.861–12T(c)(3), whether or not such stock is held directly by the U.S. shareholder.

(vi) The amount of third party interest expense of a U.S. shareholder allocated pursuant to this paragraph (e)(4) shall not exceed the total amount of the third party interest expense of the U.S. shareholder for the year (excluding any third party interest expense allocated under paragraphs (b) and (c) of §1.861–10T).

(5) *Definitions.* For purposes of this paragraph (e), the following terms shall have the following meanings.

(i) *U.S. shareholder.* The term ''U.S. shareholder'' has the same meaning as the term ''United States shareholder'' when used in section 957, except that, in the case of a United States shareholder that is a member of an affiliated group (as defined in §1.861–11T(d)), the entire affiliated group is considered to constitute a single U.S. shareholder.

(ii) *Related person.* For the definition of the term ''related person'', see §1.861–8T(c)(2). A controlled foreign

corporation is considered ''related'' to a U.S. shareholder if it is a related person with respect to the U.S. shareholder.

(6) *Determination of asset values.* A U.S. shareholder shall determine the values of the assets of each related controlled foreign corporation (for purposes of Step One in paragraph (e)(2) of this section) and the assets of the U.S. shareholder (for purposes of Step Two in paragraph (e)(3) of this section) for any year in accordance with the valuation method (tax book value or fair market value) elected for that year pursuant to §1.861–9T(g). However, solely for purposes of this paragraph (e), a U.S. shareholder may instead choose to determine the values of the assets of all related controlled foreign corporations by reference to their values as reflected on Forms 5471 (the annual information return with respect to each related controlled foreign corporation), subject to the translation rules of paragraph (e)(8)(i) of this section. This method of valuation may be used only if the taxable years of each of the related controlled foreign corporations begin with, or no more than one month earlier than, the taxable year of the U.S. shareholder. Once chosen for a taxable year, this method of valuation must be used in each subsequent taxable year and may be changed only with the consent of the Commissioner.

(7) *Adjustments to asset value.* For purposes of apportioning remaining interest expense under §1.861–9T, a U.S. shareholder shall reduce (but not below zero) the value of its assets for the year (as determined under §1.861–9T (g) (3) or (h)) by an amount equal to the allocable related group indebtedness of the U.S. shareholder for the year (as determined under Step Three in paragraph (e)(4)(ii) of this section). This reduction is allocated among assets in each separate limitation category in proportion to the average amount of related group indebtedness held by the U.S. shareholder in each separate limitation category during the year (as determined under Step Three in paragraph (e)(4)(v) of this section).

(8) *Special rules*—(i) *Exchange rates.* All indebtedness amounts and asset values (including current year and base year amounts and values) denominated in a foreign currency shall be translated into U.S. dollars at the exchange rate for the current year. The exchange rate for the current year may be determined under any reasonable method (*e.g.*, average of month-end exchange rates for each month in the current year) if it is consistently applied to the current year and all base years. Once chosen for a taxable year, a method for determining an exchange rate must be used in each subsequent taxable year and will be treated as a method of accounting for purposes of section 446. A taxpayer may apply a different translation rule only with the prior consent of the Commissioner. In this regard, the Commissioner will be guided by the extent to which a different rule would reduce the comparability of dollar amounts of indebtedness and dollar asset values for the base years and the current year.

(ii) *Exempt assets.* Solely for purposes of this paragraph (e), any exempt assets otherwise excluded under section 864(e)(3) and §1.861–8T(d) shall be included as assets of the U.S. shareholder or related controlled foreign corporation.

(iii) *Exclusion of certain directly allocated indebtedness and assets.* Qualified nonrecourse indebtedness (as defined in §1.861–10T(b)(2)) and indebtedness incurred in connection with an integrated financial transaction (as defined in §1.861–10T(c)(2)) shall be excluded from U.S. shareholder indebtedness and related group indebtedness. In addition, assets which are the subject of qualified nonrecourse indebtedness or integrated financial transactions shall be excluded from the assets of the U.S. shareholder and each related controlled foreign corporation.

(iv) *Exclusion of certain receivables.* Receivables between related controlled foreign corporations (or between members of the affiliated group constituting the U.S. shareholder) shall be excluded from the assets of the related controlled foreign corporation (or affiliated group member) holding such receivables. See also §1.861–11T(e)(1).

(v) *Classification of certain loans as related group indebtedness.* If—

(A) A U.S. shareholder owns stock in a related controlled foreign corporation which is a resident of a country that—

(*1*) Does not impose a withholding tax of 5 percent or more upon payments of dividends to a U.S. shareholder; and

(*2*) Does not, for the taxable year of the controlled foreign corporation, subject the income of the controlled foreign corporation to an income tax which is greater than that percentage specified under §1.954–1T(d)(1)(i) of the maximum rate of tax specified under section 11 of the Code, and

(B) The controlled foreign corporation has outstanding a loan or loans to one or more other related controlled foreign corporations, or the controlled foreign corporation has made a direct or indirect capital contribution to one or more other related controlled foreign corporations which have outstanding a loan or loans to one or more other related controlled foreign corporations, then, to the extent of the aggregate amount of its capital contributions in taxable years beginning after December 31, 1986, to the related controlled foreign corporation that made such loans or additional contributions, the U.S. shareholder itself shall be treated as having made the loans decribed in paragraph (e)(8)(v)(B) of this section and, thus, such loan amounts shall be considered related group indebtedness. However, for purposes of paragraph (e)(4) of this section, interest income derived by the U.S. shareholder during the year from related group indebtedness shall not include any income derived with respect to the U.S. shareholder's ownership of stock in the related controlled foreign corporation that made such loans or additional contributions.

(vi) *Classification of certain stock as related person indebtedness.* In determining the amount of its related group indebtedness for any taxable year, a U.S. shareholder must treat as related group indebtedness its holding of stock in a related controlled foreign corporation if, during such taxable year, such related controlled foreign corporation claims a deduction for interest under foreign law for distributions on such stock. However, for purposes of paragraph (e)(4) of this section, interest income derived by the U.S. shareholder during the year from related group indebtedness shall not include any income derived with respect to the U.S. shareholder's ownership of stock in the related controlled foreign corporation.

(9) *Corporate events*—(i) *Initial acquisition of a controlled foreign corporation.* If the foreign base period of the U.S. shareholder for any year includes a base year in which the U.S. shareholder did not hold stock in any related controlled foreign corporation, then, in computing the foreign base period ratio, the related group debt-to-asset ratio of the U.S. shareholder for any such base year shall be deemed to be 0.10.

(ii) *Incorporation of U.S. shareholder*—(A) *Nonapplication.* This paragraph (e) does not apply to the first taxable year of the U.S. shareholder. However, this paragraph (e) does apply to all following years, including years in which later members of the affiliated group may be incorporated.

(B) *Foreign and U.S. base period ratios.* In computing the foreign and U.S. base period ratios, the foreign and U.S. base periods of the U.S. shareholder shall be considered to be only the period prior to the current year that the U.S. shareholder was in existence if this prior period is less than five taxable years.

(iii) *Acquisition of additional corporations.* (A) If a U.S. shareholder acquires (directly or indirectly) stock of a foreign or domestic corporation which, by reason of the acquisition, then becomes a related controlled foreign corporation or a member of the affiliated group, then in determining excess related group indebtedness or excess U.S. shareholder indebtedness, the indebtedness and assets of the acquired corporation shall be taken into account only at the end of the acquisition year and in following years. Thus, amounts of indebtedness and assets and the various debt-to-asset ratios of the U.S. shareholder existing at the beginning of the acquisition year or relating to preceding years are not recalculated to take account of indebtedness and assets of the acquired corporation existing as of dates before the end of the year. If, however, a major acquisition is made within the last three months of the year and a substantial distortion of

values for the year would otherwise result, the taxpaper must take into account the average values of the acquired indebtedness and assets weighted to reflect the time such indebtedness is owed and such assets are held by the taxpayer during the year.

(B) In the case of a reverse acquisition subject to this paragraph (e)(9), the rules of § 1.1502–75(d)(3) apply in determining which corporations are the acquiring and acquired corporations. For this purpose, whether corporations are affiliated is determined under § 1.861–11T(d).

(C) If the stock of a U.S. shareholder is acquired by (and, by reason of such acquisition, the U.S. shareholder becomes affiliated with) a corporation described below, then such U.S. shareholder shall be considered to have acquired such corporation for purposes of the application of the rules of this paragraph (e). A corporation to which this paragraph (e)(9)(iii)(C) applies is—

(*1*) A corporation which is not affiliated with any other corporation (other than other similarly described corporation); and

(*2*) Substantially all of the assets of which consist of cash, securities and stock.

(iv) *Election to compute base period ratios by including acquired corporations.* A U.S. shareholder may choose, solely for purposes of paragraph (e)(9) (i) and (iii) of this section, to compute its foreign and U.S. base period ratios for the acquisition year and all subsequent years by taking into account the indebtedness and asset values of the acquired corporation or corporations (including related group indebtedness owed to a former U.S. shareholder) at the beginning of the acquisition year and in each of the five base years preceding the acquisition year. This election, if made for an acquisition, must be made for all other acquisitions occurring during the same taxable year or initiated in that year and concluded in the following year.

(v) *Dispositions.* If a U.S. shareholder disposes of stock of a foreign or domestic corporation which, by reason of the disposition, then ceases to be a related controlled foreign corporation or a member of the affiliated group (unless liquidated or merged into a related corporation), in determining excess related group indebtedness or excess U.S. shareholder indebtedness, the indebtedness and assets of the divested corporation shall be taken into account only at the beginning of the disposition year and for the relevant preceding years. Thus, amounts of indebtedness and assets and the various debt-to-asset ratios of the U.S. shareholder existing at the end of the year or relating to following years are not affected by indebtedness and assets of the divested corporation existing as of dates after the beginning of the year. If, however, a major disposition is made within the first three months of the year and a substantial distortion of values for the year would otherwise result, the taxpayer must take into account the average values of the divested indebtedness and assets weighted to reflect the time such indebtedness is owed and such assets are held by the taxpayer during the year.

(vi) *Election to compute base period ratios by excluding divested corporations.* A U.S. shareholder may choose, solely for purposes of paragraph (e) (9) (v) and (vii) of this section, to compute its foreign and U.S. base period ratios for the disposition year and all subsequent years without taking into account the indebtedness and asset values of the divested corporation or corporations at the beginning of the disposition year and in each of the five base years preceding the disposition year. This election, if made for a disposition, must be made for all other dispositions occurring during the same taxable year or initiated in that year and concluded in the following year.

(vii) *Section 355 transactions.* A U.S. corporation which becomes a separate U.S. shareholder as a result of a distribution of its stock to which section 355 applies shall be considered—

(A) As disposed of by the U.S. shareholder of the affiliated group of which the distributing corporation is a member, with this disposition subject to the rules of paragraphs (e) (9) (v) and (vi) of this section; and

(B) As having the same related group debt-to-asset ratio and debt-to-asset ratio as the distributing U.S. shareholder in each year preceding the year of distribution for purposes of applying

this paragraph (e) to the year of distibution and subsequent years of the distributed corporation.

(10) *Effective date*—(i) *Taxable years beginning after December 31, 1991.* The provisions of this paragraph (e) apply to all taxable years beginning after December 31, 1991.

(ii) *Taxable years beginning after December 31, 1987 and before January 1, 1992.* The provisions of §1.861–10T (e) apply to taxable years beginning after December 31, 1987, and before January 1, 1992. The taxpayer may elect to apply the provisions of this paragraph (e) (in lieu of the provisions of §1.861–10T (e)) for any taxable year beginning after December 31, 1987, but this paragraph (e) must then be applied to all subsequent taxable years.

(11) The following example illustrates the provisions of this paragraph (e):

Example. (i) *Facts.* X, a domestic corporation, elects to apply this paragraph (e) to its 1990 tax year. X has a calendar taxable year and apportions its interest expense on the basis of the tax book value of its assets. In 1990, X incurred deductible third-party interest expense of $24,960 on an average amount of indebtedness (determined on the basis of beginning-of-year and end-of-year amounts) of $249,600. X manufactures widgets, all of which are sold in the United States. X owns all of the stock of Y, a controlled foreign corporation that also has a calendar taxable year and is also engaged in the manufacture and sale of widgets. Y has no earnings and profits or deficit of earnings and profits attributable to taxable years prior to 1987. X's total assets and their average tax book values (determined on the basis of beginning-of-year and end-of-year tax book values) for 1990 are:

Asset	Average tax book value
Plant and equipment	$315,000
Corporate headquarters	60,000
Y stock	75,000
Y note	50,000
Total	500,000

Y had $25,000 of income before the deduction of any interest expense. Of this total, $5,000 is high withholding tax interest income. The remaining $20,000 is derived from widget sales, and constitutes foreign source general limitation income. Assume that Y has no deductions from gross income other than interest expense. During 1990, Y paid $5,000 of interest expense to X on the Y note and $10,000 of interest expense to third parties, giving Y total interest expense of $15,000. X elects pursuant to §1.861–9T to apportion Y's interest expense under the gross income method prescribed in section 1.861–9T (j).

(ii) *Step 1:* Using a beginning and end of year average, X (the U.S. shareholder) held the following average amounts of indebtedness of Y and Y had the following average asset values:

	1985	1986–88	1989	1990
(A) Related group indebtedness	$11,000	24,000	26,000	50,000
(B) Average Value of Assets of Related CFC	100,000	200,000	200,000	250,000
(C) Related Group Debt-to-Asset Ratio	.11	.12	.13	.20

(*1*) X's ''foreign base period ratio'' for 1990, an average of its ratios of related group indebtedness to related group assets for 1985 through 1989, is:

(.11 + .12 + .12 + .12 + .13) / 5 = .12

(*2*) X's ''allowable related group indebtedness'' for 1990 is:

$250,000 × .12 = $30,000.

(*3*) X's ''excess related group indebtedness'' for 1990 is:

$50,000 − $30,000 = $20,000

X's related group indebtedness of $50,000 for 1990 is greater than its allowable related group indebtedness of $24,000 for 1989 (assuming a foreign base period ratio in 1989 of .12), and X's related group debt-to-asset ratio for 1990 is .20, which is greater than the ratio of .10 described in paragraph (e)(2)(vii)(B) of this section. Therefore, X's excess related group indebtedness for 1990 remains at $20,000.

(iii) *Step 2:* Using a beginning and end of year average, X has the following average amounts of U.S. and foreign indebtedness and average asset values:

	1985	1986	1987	1988	1989	1990
(1)	$231,400	225,000	225,000	225,000	220,800	249,600
(2)	445,000	450,000	450,000	450,000	460,000	480,000
(3)	.52	.50	.50	.50	.48	(a) .52

(1) U.S. and foreign indebtedness

(2) Average value of assets of U.S. shareholder

(3) Debt-to-Asset ratio of U.S. shareholder

(a) [500,000–20,000 (excess related group indebtedness determined in Step 1)]

X's ''U.S. base period ratio'' for 1990 is:

(.52 + .50 + .50 + .50 + .48) / 5 = .50

X's ''allowable indebtedness'' for 1990 is:

$480,000 × .50 = $240,000

X's ''excess U.S. shareholder indebtedness'' for 1990 is:

$249,000 − $240,000 = $9,600

X's debt-to-asset ratio for 1990 is .52, which is greater than the ratio of .10 described in paragraph (e)(3)(vii) of this section. Therefore, X's excess U.S. shareholder indebtedness for 1990 remains at $9,600.

(iv) *Step 3:* (a) Since X's excess U.S. shareholder indebtedness of $9,600 is less than its excess related group indebtedness of $20,000, X's allocable related group indebtedness for 1990 is $9,600. The amount of interest received by X during 1990 on allocable related group indebtedness is:

$5,000 × $9,600 / $50,000 = $960

(b) Therefore, $960 of X's third party interest expense ($24,960) shall be allocated among various separate limitation categories in proportion to the relative average amounts of Y obligations held by X in each such category. The amount of Y obligations in each limitation category is determined in the same manner as the stock of Y would be attributed under the rules of §1.861–12T(c)(3). Since Y's interest expense is apportioned under the gross income method prescribed in §1.861–9T (j), the Y stock must be characterized under the gross income method described in §1.861–12T(c)(3)(iii). Y's gross income net of interest expense is determined as follows:

Foreign source high withholding tax interest income

= $5,000 − [($15,000) multiplied by ($5,000)/($5,000 + $20,000)]

= $2,000

and

Foreign source general limitation income

= $20,000 − [($15,000) multiplied by ($20,000)/($5,000 + $20,000)]

= $8,000.

(c) Therefore, $192 [($960 × $2,000/($2,000 + $8,000)] of X's third party interest expense is allocated to foreign source high withholding tax interest income and $768 [$960 × $8,000/($2,000 + $8,000)] is allocated to foreign source general limitation income.

(v) As a result of these direct allocations, for purposes of apportioning X's remaining interest expense under §1.861–9T, the value of X's assets generating foreign source general limitation income is reduced by the principal amount of indebtedness the interest on which is directly allocated to foreign source general limitation income ($7,680), and the value of X's assets generating foreign source high withholding tax interest income is reduced by the principal amount of indebtedness the interest on which is directly allocated to foreign source high withholding tax interest income ($1,920), determined as follows:

Reduction of X's assets generating foreign source general limitation income:

$$\text{X's allocable related group indebtedness} \times \frac{\text{Y's Foreign source general limitation income}}{\text{Y's Foreign source income}}$$

$$\$9{,}600 \times \$8{,}000/(\$8{,}000 + \$2{,}000) = \$7{,}680$$

Reduction of X's assets generating foreign source high withholding tax interest income:

$$\text{X's allocable related group indebtedness} \times \frac{\text{Y's Foreign source high withholding tax interest income}}{\text{Y's Foreign source income}}$$

$$\$9{,}600 \times \$2{,}000/(\$8{,}000 + \$2{,}000) = \$1{,}920$$

[T.D. 8410, 57 FR 13022, Apr. 15, 1992; 57 FR 28012, June 23, 1992]

§ 1.861–10T Special allocations of interest expense (temporary).

(a) *In general.* This section applies to all taxpayers and provides three exceptions to the rules of § 1.861–9T that require the allocation and apportionment of interest expense on the basis of all assets of all members of the affiliated group. Paragraph (b) of this section describes the direct allocation of interest expense to the income generated by certain assets that are subject to qualified nonrecourse indebtedness. Paragraph (c) of this section describes the direct allocation of interest expense to income generated by certain assets that are acquired in integrated financial transaction. Paragraph (d) of this section provides special rules that are applicable to all transactions described in paragraphs (b) and (c) of this section. Paragraph (e) of this section requires the direct allocation of third party interest of an affiliated group to such group's investment in related controlled foreign corporations in cases involving excess related person indebtedness (as defined therein). See also § 1.861–9T(b)(5), which requires direct allocation of amortizable bond premium.

(b) *Qualified nonrecourse indebtedness*—(1) *In general.* In the case of qualified nonrecourse indebtedness (as defined in paragraph (b)(2) of this section), the deduction for interest shall be considered directly allocable solely to the gross income which the property acquired, constructed, or improved with the proceeds of the indebtedness generates, has generated, or could reasonably be expected to generate.

(2) *Qualified nonrecourse indebtedness defined.* The term ''qualified nonrecourse indebtedness'' means any borrowing that is not excluded by paragraph (b)(4) of this section if:

(i) The borrowing is specifically incurred for the purpose of purchasing, constructing, or improving identified property that is either depreciable tangible personal property or real property with a useful life of more than one year or for the purpose of purchasing amortizable intangible personal property with a useful life of more than one year;

(ii) The proceeds are actually applied to purchase, construct, or improve the identified property;

(iii) Except as provided in paragraph (b)(7)(ii) (relating to certain third party guarantees in leveraged lease transactions), the creditor can look only to the identified property (or any lease or other interest therein) as security for payment of the principal and interest on the loan and, thus, cannot look to any other property, the borrower, or any third party with respect to repayment of principal or interest on the loan;

(iv) The cash flow from the property, as defined in paragraph (b)(3) of this section, is reasonably expected to be sufficient in the first year of ownership as well as in each subsequent year of ownership to fulfill the terms and conditions of the loan agreement with respect to the amount and timing of payments of interest and original issue discount and periodic payments of principal in each such year; and

(v) There are restrictions in the loan agreement on the disposal or use of the property consistent with the assumptions described in subdivisions (iii) and (iv) of this paragraph (b)(2).

(3) *Cash flow defined*—(i) *In general.* The term ''cash flow from the property'' as used in paragraph (b)(2)(iv) of this section means a stream of revenue (as computed under paragraph (b)(3)(ii) of this section) substantially all of which derives directly from the property. The phrase ''cash flow from the property'' does not include revenue if a significant portion thereof is derived from activities such as sales, labor, services, or the use of other property. Thus, revenue derived from the sale or lease of inventory or of similar property does not constitute cash flow from the property, including plant or equipment used in the manufacture and sale or lease, or purchase and sale or lease, of such inventory or similar property. In addition, revenue derived in part from the performance of services that are not ancillary and subsidiary to the use of property does not constitute cash flow from the property.

(ii) *Self-constructed assets.* The activities associated with self-construction of assets shall be considered to constitute labor or services for purposes of

paragraph (b)(3)(i) only if the self-constructed asset—

(A) Is constructed for the purpose of resale, or

(B) Without regard to purpose, is sold to an unrelated person within one year from the date that the property is placed in service for purposes of section 167.

(iii) *Computation of cash flow.* Cash flow is computed by subtracting cash disbursements excluding debt service from cash receipts.

(iv) *Analysis of operating costs.* [Reserved]

(v) *Examples.* The principles of this paragraph may be demonstrated by the following examples.

Example 1. In 1987, X borrows $100,000 in order to purchase an apartment building, which X then purchases. The loan is secured only by the building and the leases thereon. Annual debt service on the loan is $12,000. Annual gross rents from the building are $20,000. Annual taxes on the building are $2,000. Other expenses deductible under section 162 are $2,000. Rents are reasonably expected to remain stable or increase in subsequent years, and taxes and expenses are reasonably expected to remain proportional to gross rents in subsequent years. X provides security, maintenance, and utilities to the tenants of the building. Based on facts and circumstances, it is determined that, although services are provided to tenants, these services are ancillary and subsidiary to the occupancy of the apartments. Accordingly, the case flow of $16,000 is considered to constitute a return from the property. Furthermore, such cash flow is sufficient to fulfill the terms and conditions of the loan agreement as required by paragraph (b)(2)(iii).

Example 2. In 1987, X borrows funds in order to purchase a hotel, which X then purchases and operates. The loan is secured only by the hotel. Based on facts and circumstances, it is determined that the operation of the hotel involves services the value of which is significant in relation to amounts paid to occupy the rooms. Thus, a significant portion of the cash flow is derived from the performance of services incidental to the occupancy of hotel rooms. Accordingly, the cash flow from the hotel is considered not to constitute a return on or from the property.

Example 3. In 1987, X borrows funds in order to build a factory, which X then builds and operates. The loan is secured only by the factory and the equipment therein. Based on the facts and circumstances, it is determined that the operation of the factory involves significant expenditures for labor and raw materials. Thus, a significant portion of the cash flow is derived from labor and the processing of raw materials. Accordingly, the cash flow from the factory is considered not to constitute a return on or from the property.

(4) *Exclusions.* The term ''qualified nonrecourse indebtedness'' shall not include any transaction that—

(i) Lacks economic significance within the meaning of paragraph (b)(5) of this section;

(ii) Involves cross collateralization within the meaning of paragraph (b)(6) of this section;

(iii) Except in the case of a leveraged lease described in paragraph (b)(7)(ii) of this section, involves credit enhancement within the meaning of paragraph (b)(7) of this section or, with respect to loans made on or after October 14, 1988, does not under the terms of the loan documents, prohibit the acquisition by the holder of bond insurance or similar forms of credit enhancement;

(iv) Involves the purchase of inventory;

(v) Involves the purchase of any financial asset, including stock in a corporation, an interest in a partnership or a trust, or the debt obligation of any obligor (although interest incurred in order to purchase certain financial instruments may qualify for direct allocation under paragraph (c) of this section);

(vi) Involves interest expense that constitutes qualified residence interest as defined in section 163(h)(3); or

(vii) [Reserved]

(5) *Economic significance.* Indebtedness that otherwise qualifies under paragraph (b)(2) shall nonetheless be subject to apportionment under § 1.861–9T if, taking into account all the facts and circumstances, the transaction (including the security arrangement) lacks economic significance.

(6) *Cross collateralization.* The term ''cross collateralization'' refers to the pledge as security for a loan of—

(i) Any asset of the borrower other than the identified property described in paragraph (b)(2) of this section, or

(ii) Any asset belonging to any related person, as defined in § 1.861–8T(c)(2).

(7) *Credit enhancement*—(i) *In general.* Except as provided in paragraph (b)(7)(ii) of this section, the term

''credit enhancement'' refers to any device, including a contract, letter of credit, or guaranty, that expands the creditor's rights, directly or indirectly, beyond the identified property purchased, constructed, or improved with the funds advanced and, thus effectively provides as security for a loan the assets of any person other than the borrower. The acquisition of bond insurance or any other contract of suretyship by an initial or subsequent holder of an obligation shall constitute credit enhancement.

(ii) *Special rule for leveraged leases.* For purposes of this paragraph (b), the term ''credit enhancement'' shall not include any device under which any person that is not a related person within the meaning of § 1.861–8T(c)(2) agrees to guarantee, without recourse to the lessor or any person related to the lessor, a lessor's payment of principal and interest on indebtedness that was incurred in order to purchase or improve an asset that is depreciable tangible personal property or depreciable tangible real property (and the land on which such real property is situated) that is leased to a lessee that is not a related person in a transaction that constitutes a lease for federal income tax purposes.

(iii) *Syndication of credit risk and sale of loan participations.* The term ''syndication of credit risk'' refers to an arrangement in which one primary lender secures the promise of a secondary lender to bear a portion of the primary lender's credit risk on a loan. The term ''sale of loan participations'' refers to an arrangement in which one primary lender divides a loan into several portions, sells and assigns all rights with respect to one or more portions to participating secondary lenders, and does not remain at risk in any manner with respect to the portion assigned. For purposes of this paragraph (b), the syndication of credit risk shall constitute credit enhancement because the primary lender can look to secondary lenders for payment of the loan, notwithstanding limitations on the amount of the secondary lender's liability. Conversely, the sale of loan participations does not constitute credit enhancement, because the holder of each portion of the loan can look solely to the asset securing the loan and not to the credit or other assets of any person.

(8) *Other arrangements that do not constitute cross collateralization or credit enhancement.* For purposes of paragraphs (b) (6) and (7) of this section, the following arrangements do not constitute cross collateralization or credit enhancement:

(i) *Integrated projects.* A taxpayer's pledge of multiple assets of an integrated project, provided that the integrated project. An integrated project consists of functionally related and geographically contiguous assets that, as to the taxpayer, are used in the same trade or business.

(ii) Insurance. A taxpayer's purchase of third-party casualty and liability insurance on the collateral or, by contract, bearing the risk of loss associated with destruction of the collateral or with respect to the attachment of third party liability claims.

(iii) *After-acquired property.* Extension of a creditor's security interest to improvements made to the collateral, provided that the extension does not constitute excess collateralization under paragraph (b)(6), determined by taking into account the value of improvements at the time the improvements are made and the value of the original property at the time the loan was made.

(iv) *Warranties of completion and maintenance.* A taxpayer's warranty to a creditor that it will complete construction or manufacture of the collateral or that it will maintain the collateral in good condition.

(v) *Substitution of collateral.* A taxpayer's right to substitute collateral under any loan contract. However, after the right is exercised, the loan shall no longer constitute qualified nonrecourse indebtedness.

(9) *Refinancings.* If a taxpayer refinances qualified nonrecourse indebtedness (as defined in paragraph (b)(2) of this section) with new indebtedness, such new indebtedness shall continue to qualify only if—

(i) The principal amount of the new indebtedness does not exceed by more than five percent the remaining principal amount of the original indebtedness,

(ii) The term of the new indebtedness does not exceed by more than six months the remaining term of the original indebtedness, and

(iii) The requirements of this paragraph (other than those of paragraph (b)(2) (i) and (ii) of this section) are satisfied at the time of the refinancing, and the exclusions contained in this paragraph (b)(4) do not apply.

(10) *Post-construction permanent financing*. Financing that is obtained after the completion of constructed property will be deemed to satisfy the requirements of paragraph (b)(2) (i) and (ii) of this section if—

(i) The financing is obtained within one year after the constructed property or substantially all of a constructed integrated project (as defined in paragraph (b)(9)(i) of this section) is placed in service for purposes of section 167; and

(ii) The financing does not exceed the cost of construction (including construction period interest).

(11) *Assumptions of pre-existing qualified nonrecourse indebtedness*. If a transferee of property that is subject to qualified nonrecourse indebtedness assumes such indebtedness, the indebtedness shall continue to constitute qualified nonrecourse indebtedness, provided that the assumption in no way alters the qualified status of the debt.

(12) *Excess collateralization*. [Reserved]

(c) *Direct allocations in the case of certain integrated financial transactions*—(1) *General rule*. Interest expense incurred on funds borrowed in connection with an integrated financial transaction (as defined in paragraph (c)(2) of this section) shall be directly allocated to the income generated by the investment funded with the borrowed amounts.

(2) *Definition*. The term ''integrated financial transaction'' refers to any transaction in which—

(i) The taxpayer—

(A) Incurs indebtedness for the purpose of making an identified term investment,

(B) Identifies the indebtedness as incurred for such purpose at the time the indebtedness is incurred, and

(C) Makes the identified term investment within ten business days after incurring the indebtedness;

(ii) The return on the investment is reasonably expected to be sufficient throughout the term of the investment to fulfill the terms and conditions of the loan agreement with respect to the amount and timing of payments of principal and interest or original issue discount;

(iii) The income constitutes interest or original issue discount or would constitute income equivalent to interest if earned by a controlled foreign corporation (as described in § 1.954–2T(h));

(iv) The debt incurred and the investment mature within ten business days of each other;

(v) The investment does not relate in any way to the operation of, and is not made in the normal course of, the trade or business of the taxpayer or any related person, including the financing of the sale of goods or the performance of services by the taxpayer or any related person, or the compensation of the taxpayer's employees (including any contribution or loan to an employee stock ownership plan (as defined in section 4975(e)(7)) or other plan that is qualified under section 401(a)); and

(vi) The borrower does not constitute a financial services entity (as defined in section 904 and the regulations thereunder).

(3) *Rollovers*. In the event that a taxpayer sells of otherwise liquidates an investment described in paragraph (c)(2) of this section, the interest expense incurred on the borrowing shall, subsequent to that liquidation, no longer qualify for direct allocation under this paragraph (c).

(4) *Examples*. The principles of this paragraph (c) may be demonstrated by the following examples.

Example 1. X is a manufacturer and does not constitute a financial services entity as defined in the regulations under section 904. On January 1, 1988, X borrows $100 for 6 months at an annual interest rate of 10 percent. X identifies on its books and records by the close of that day that the indebtedness is being incurred for the purpose of making an investment that is intended to qualify as an integrated financial transaction. On January 5, 1988, X uses the proceeds to purchase a portfolio of stock that approximates the composition of the Standard & Poor's 500 Index. On that day, X also enters into a forward sale contract that requires X to sell the stock on June 1, 1988 for $110. X identifies on its books and records by the close of January

5, 1988, that the portfolio stock purchases and the forward sale contract constitute part of the integrated financial transaction with respect to which the identified borrowing was incurred. Under § 1.954–2T(h), the income derived from the transaction would constitute income equivalent to interest. Assuming that the return on the investment to be derived on June 1, 1988, will be sufficient to pay the interest due on June 1, 1988, the interest on the borrowing is directly allocated to the gain from the investment.

Example 2. X does not constitute a financial services entity as defined in the regulations under section 904. X is in the business of, among other things, issuing credit cards to consumers and purchasing from merchants who accept the X card the receivables of consumers who make purchases with the X card. X borrows from Y in order to purchase X credit card receivables from Z, a merchant. Assuming that the Y borrowing satisfies the other requirements of paragraph (c)(2) of this section, the transaction nonetheless cannot constitute an integrated financial transaction because the purchase relates to the operation of X's trade or business.

Example 3. Assume the same facts as in Example 2, except that X borrows in order to purchase the receivables of A, a merchant who does not accept the X card and is not otherwise engaged directly or indirectly in any business transaction with X. Because the borrowing is not related to the operation of X's trade or business, the borrowing may qualify as an integrated financial transaction if the other requirements of paragraph (c)(2) of this section are satisfied.

(d) *Special rules.* In applying paragraphs (b) and (c) of this section, the following special rules shall apply.

(1) *Related person transactions.* The rules of this section shall not apply to the extent that any transaction—

(i) Involves either indebtedness between related persons (as defined in section § 1.861–8T(c)(2)) or indebtedness incurred from unrelated persons for the purpose of purchasing property from a related person; or

(ii) Involves the purchase of property that is leased to a related person (as defined in § 1.861–8T(c)(2)) in a transaction described in paragraph (b) of this section. If a taxpayer purchases property and leases such property in whole or in part to a related person, a portion of the interest incurred in connection with such an acquisition, based on the ratio that the value of the property leased to the related person bears to the total value of the property, shall not qualify for direct allocation under this section.

(2) *Consideration of assets or income to which interest is directly allocated in apportioning other interest expense.* In apportioning interest expense under § 1.861–9T, the year-end value of any asset to which interest expense is directly allocated under this section during the current taxable year shall be reduced to the extent provided in § 1.861–9T(g)(2)(iii) to reflect the portion of the principal amount of the indebtedness outstanding at year-end relating to the interest which is directly allocated. A similar adjustment shall be made to the end-of-year value of assets for the prior year for purposes of determining the beginning-of-year value of assets for the current year. These adjustments shall be made prior to averaging beginning-of-year and end-of-year values pursuant to § 1.861–9T(g)(2). In apportioning interest expense under the modified gross income method, gross income shall be reduced by the amount of income to which interest expense is directly allocated under this section.

(e) *Treatment of certain related controlled foreign corporation indebtedness*—(1) *In general.* In taxable years beginning after 1987, if a United States shareholder has incurred substantially disproportionate indebtedness in relation to the indebtedness of its related controlled foreign corporations so that such corporations have excess related person indebtedness (as determined under step 4 in subdivision (iv) of this paragraph (e)(1), the third party interest expense of the related United States shareholder (excluding amounts allocated under paragraphs (b) and (c)) in an amount equal to the interest income received on such excess related person indebtedness shall be allocated to gross income in the various separate limitation categories described in section 904(d)(1) in the manner prescribed in step 6 in subdivision (vi) of this paragraph (e)(1). This computation shall be performed as follows.

(i) *Step 1: Compute the debt-to-asset ratio of the related United States shareholder.* The debt-to-asset ratio of the related United States shareholder is the ratio between—

(A) The average month-end debt level of the related United States shareholder taking into account debt owing to any obligee who is not a related person as defined in section § 1.861–8T(c)(2), and

(B) The value of assets (tax book or fair market) of the related United States shareholder including stockholdings and obligations of related controlled foreign corporations but excluding stockholdings and obligations of members of the affiliated group (as defined in § 1.861–11T(d)).

(ii) *Step 2: Compute aggregate debt-to-asset ratio of all related controlled foreign corporations.* The aggregate debt-to-asset ratio of all related controlled foreign corporations is the ratio between—

(A) The average aggregate month-end debt level of all related controlled foreign corporations for their taxable years ending during the related United States shareholder's taxable year taking into account only indebtedness owing to persons other than the related United States shareholder or the related United States shareholder's other related controlled foreign corporations (''third party indebtedness''), and

(B) The aggregate value (tax book or fair market) of the assets of all related controlled foreign corporations for their taxable years ending during the related United States shareholder's taxable year excluding stockholdings in and obligations of the related United States shareholder or the related United States shareholder's other related controlled foreign corporations.

(iii) *Step 3: Compute aggregate related person debt of all related controlled foreign corporations.* This amount equals the average aggregate month-end debt level of all related controlled foreign corporations for their taxable years ending with or within the related United States shareholder's taxable year, taking into account only debt which is owned to the related United States shareholder (''related person indebtedness'').

(iv) *Step 4: Computation of excess related person indebtedness and computation of the income therefrom*—(A) *General rule.* If the ratio computed under step 2 is less than applicable percentage of the ratio computed under step 1, the taxpayer shall add to the aggregate third party indebtedness of all related controlled foreign corporations determined under paragraph (e)(1)(ii)(A) of this section that portion of the related person indebtedness computed under step 3 that, when combined with the aggregate third party indebtedness of all controlled foreign corporations, makes the ratio computed under step 2 equal to applicable percentage of the ratio computed under step 1. The amount of aggregate related person debt that is so added to the aggregate third party debt of related controlled foreign corporations is considered to constitute excess related person indebtedness. For purposes of this paragraph (e)(1)(iv)(A), the term ''applicable percentage'' means the designated percentages for taxable years beginning during the following calendar years:

Taxable years beginning in	Applicable percentage
1988	50
1989	65
1990 and thereafter	80

(B) *Elective quadratic formula.* In calculating the amount of excess related party indebtedness of related controlled foreign corporations, the United States shareholder's debt-to-asset ratio may be adjusted to reflect the amount by which its debt and assets would be reduced had the related controlled foreign corporations incurred the excess related party indebtedness directly to third parties. In such case, the ratio computed in Step 1 is adjusted to reflect a reduction of both portions of the ratio by the amount of excess related person indebtedness as computed under this paragraph (e)(1)(ii)(A). Excess related person indebtedness may be computed under the following formula, under which excess related person indebtedness equals the smallest positive amount (not exceeding the aggregate amount of related controlled foreign corporation indebtedness) that is a solution to the following formula (with X equalling the amount of excess related person indebtedness):

$$\frac{\text{Aggregate third party debt of related US shareholder} - X}{\text{US shareholder assets} - X} \times \text{Applicable percentage for year} = \frac{\text{Aggregate third party debt of related CFCs} + X}{\text{Related CFC assets}}$$

Guidance concerning the solution of this equation is set forth in *Example* (2) of § 1.861–12(k).

(C) *Computation of interest income received on excess related party indebtedness.* The amount of interest income received on excess related person indebtedness equals the total interest income on related person indebtedness derived by the related United States shareholder during the taxable year multiplied by the ratio of excess related person indebtedness over the aggregate related person indebtedness for the taxable year.

(v) *Step 5: Determine the aggregate amount of related controlled foreign corporation obligations held by the related United States shareholder in each limitation category.* The aggregate amount of related controlled foreign corporation obligations held by the related United States shareholder in each limitation category equals the sum of the value of all such obligations in each limitation category. Solely for purposes of this paragraph (e)(1)(v), each debt obligation in a related controlled foreign corporation held by a related United States shareholder shall be attributed to separate limitation categories in the same manner as the stock of the obligor would be attributed under the rules of § 1.861–12T(c)(3), whether or nor such stock is held directly by such related United States shareholder.

(vi) *Step 6: Direct allocation of United States shareholder third party interest expense.* Third party interest expense of the related United States shareholder equal to the amount of interest income received on excess related person indebtedness as determined in step 4 shall be allocated among the various separate limitation categories in proportion to the relative aggregate amount of related controlled foreign corporation obligations held by the related United States shareholder in each such category, as determined under step 5. The remaining portion of third party interest expense will be apportioned as provided in §§ 1.861–8T through 1.861–13T, excluding this paragraph.

(2) *Definitions*—(i) *United States shareholder.* For purposes of this paragraph, the term ''United States shareholder'' has the same meaning as defined by section 957, except that, in the case of a United States shareholder that is a member an affiliated group (as defined in § 1.861–11T(d)), the entire affiliated group shall be considered to constitute a single United States shareholder. The term ''related United States shareholder'' is the United States shareholder (as defined in this paragraph (e)(2)(i)) with respect to which related controlled foreign corporations (as defined in paragraph (e)(2)(ii) of this section) are related within the meaning of that paragraph.

(ii) *Related controlled foreign corporation.* For purposes of this section, the term ''related controlled foreign corporation'' means any controlled foreign corporation which is a related person (as defined in § 1.861–8T(c)(2)) to a United States shareholder (as defined paragraph (e)(2)(i) of this section).

(iii) *Value of assets and amount of liabilities.* For purposes of this section, the value of assets is determined under § 1.861–9T(g). Thus, in the case of assets that are denominated in foreign currency, the average of the beginning-of-year and end-of-year values is determined in foreign currency and translated into dollars using exchange rates on the last day of the related United States shareholder's taxable year. In the case of liabilities that are denominated in foreign currency, the average month-end debt level of such liabilities is determined in foreign currency and then translated into dollars using exchange rates on the last day of the related United States shareholder's taxable year.

(3) *Treatment of certain stock.* To the extent that there is insufficient related person indebtedness of all related controlled foreign corporations under step 3 in paragraph (e)(1)(iii) of this section to achieve as equal ratio in step 4 of

paragraph (e)(1)(iv) of this section, certain stock held by the related United States shareholder will be treated as related person indebtedness. Such stock includes—

(i) Any stock in the related controlled foreign corporation that is treated in the same manner as debt under the law of any foreign country that grants a deduction for interest or original issue discount relating to such stock, and

(ii) Any stock in a related controlled foreign corporation that has made loans to, or held stock described in this paragraph (e)(3) in, another related controlled foreign corporation. However, such stock shall be treated as related person indebtedness only to the extent of the principal amount of such loans.

For purposes of computing income from excess related person indebtedness in step 4 of paragraph (e)(1)(iv) of this section, stock that is treated under this paragraph as related person indebtedness shall be considered to yield interest in an amount equal to the interest that would be computed on an equal amount of indebtedness under section 1274. Only dividends actually paid thereon shall be included in gross income for other purposes.

(4) *Adjustments to assets in apportioning other interest expense.* In apportioning interest expense under § 1.861–9T, the value of assets in each separate limitation category for the taxable year as determined under § 1.861–9T(g)(3) shall be reduced (but not below zero) by the principal amount of third party indebtedness of the related United States shareholder the interest expense on which is allocated to each such category under paragraph (e)(1) of this section.

(5) *Exceptions*—(i) *Per company rule.* If—

(A) A related controlled foreign corporation with obligations owing to a related United States shareholder has a greater proportion of passive assets than the proportion of passive assets held by the related United States shareholder,

(B) Such passive assets are held in liquid or short term investments, and

(C) There are frequent cash transfers between the related controlled foreign corporation and the related United States shareholder,

the Commissioner, in his discretion, may choose to exclude such a corporation from other related controlled foreign corporations in the application of the rules of this paragraph (e).

(ii) *Aggregate rule.* If it is determined that, in aggregate, the application of the rules of this paragraph (e) increases a taxpayer's foreign tax credit as determined under section 901(a), the Commissioner, in his discretion, may choose not to apply the rules of this paragraph. If the Commissioner exercises discretion under this paragraph (e)(5)(ii), then paragraph (e) shall not apply to any extent to any interest expense of the taxpayer.

(f) *Effective/applicability date.* (1) In general, the rules of this section apply for taxable years beginning after December 31, 1986.

(2) Paragraphs (b)(3)(ii) (providing an operating costs test for purposes of the nonrecourse indebtedness exception) and (b)(6) (concerning excess collaterization of nonrecourse borrowings) of this section are applicable for taxable years commencing after December 31, 1988.

(3) Paragraph (e) (concerning the treatment of related controlled foreign corporation indebtedness) of this section is applicable for taxable years commencing after December 31, 1987. For rules for taxable years beginning before January 1, 1987, and for later years to the extent permitted by § 1.861–13T, *see* § 1.861–8 (revised as of April 1, 1986).

[T.D. 8228, 53 FR 35485, Sept. 14, 1988, as amended by T.D. 9456, 74 FR 38875, Aug. 4, 2009]

§ 1.861–11 Special rules for allocating and apportioning interest expense of an affiliated group of corporations.

(a)–(c) [Reserved]. For further guidance, see § 1.861–11T(a) through (c).

(d) *Definition of affiliated group*—(1) *General rule.* For purposes of this section, in general, the term *affiliated group* has the same meaning as is given that term by section 1504, except that section 936 corporations are also included within the affiliated group to the extent provided in paragraph (d)(2)

of this section. Section 1504(a) defines an affiliated group as one or more chains of includible corporations connected through 80-percent stock ownership with a common parent corporation which is an includible corporation (as defined in section 1504(b)). In the case of a corporation that either becomes or ceases to be a member of the group during the course of the corporation's taxable year, only the interest expense incurred by the group member during the period of membership shall be allocated and apportioned as if all members of the group were a single corporation. In this regard, assets held during the period of membership shall be taken into account. Other interest expense incurred by the group member during its taxable year but not during the period of membership shall be allocated and apportioned without regard to the other members of the group.

(2) *Inclusion of section 936 corporations*—(i) *Rule*—(A) *In general*. Except as otherwise provided in paragraph (d)(2)(i)(B) of this section, the exclusion of section 936 corporations from the affiliated group under section 1504(b)(4) does not apply for purposes of this section. Thus, a section 936 corporation that meets the ownership requirements of section 1504(a) is a member of the affiliated group.

(B) *Exception for purposes of alternative minimum tax*. The exclusion from the affiliated group of section 936 corporations under section 1504(b)(4) shall be operative for purposes of the application of this section solely in determining the amount of foreign source alternative minimum taxable income within each separate category and the alternative minimum tax foreign tax credit pursuant to section 59(a). Thus, a section 936 corporation that meets the ownership requirements of section 1504(a) is not a member of the affiliated group for purposes of determining the amount of foreign source alternative minimum taxable income within each separate category and the alternative minimum tax foreign tax credit pursuant to section 59(a).

(ii) *Section 936 corporation defined*. For purposes of this section, § 1.861–9, and § 1.861–14, the term *section 936 corporation* means, for any taxable year, a corporation with an election in effect to be eligible for the credit provided under section 936(a)(1) or section 30A for the taxable year.

(iii) *Example*. This example illustrates the provisions of paragraph (d)(2)(i) of this section:

Example. (A) *Facts*. X owns all of the stock of Y. XY constitutes an affiliated group of corporations within the meaning of section 1504(a) and uses the tax book value method of apportionment. In 2000, Y owns all of the stock of Z, a section 936 corporation. Z manufactures widgets in Puerto Rico. Y purchases these widgets and markets them exclusively in the United States. Of the three corporations, only Z has foreign source income, which includes both qualified possessions source investment income and general limitation income. For purposes of section 904, Z's qualified possessions source investment income constitutes foreign source passive income. In computing the section 30A benefit, Y and Z have elected the cost sharing method. Of the three corporations, only X has debt and, thus, only X incurs interest expense.

(B) *Analysis for regular tax*. Assume first that X has no alternative minimum tax liability. Under paragraph (d)(2) of this section, Z is treated as a member of the XY affiliated group for purposes of allocating and apportioning interest expense for regular tax purposes. As provided in § 1.861–11T(b)(2), section 864(e)(1) and (5) do not apply in computing the combined taxable income of Y and Z under section 936, but these rules do apply in computing the foreign source taxable income of the XY affiliated group. The effect of including Z in the affiliated group is that X, the only debtor corporation in the group, must, under the asset method described in § 1.861–9T(g), apportion a part of its interest expense to foreign source passive income and foreign source general limitation income. This is because the assets of Z that generate qualified possessions source investment income and general limitation income are included in computing the group apportionment fractions. The result is that, under section 904(f), X has an overall foreign loss in both the passive and general limitation categories, which currently offsets domestic income and must be recaptured against any subsequent years' foreign passive income and general limitation income, respectively, under the rules of that section.

(C) *Analysis for alternative minimum tax*. Assume, alternatively, that X is liable to pay the alternative minimum tax. Pursuant to section 59(a), X must compute its alternative minimum tax foreign tax credit as if section 904 were applied on the basis of alternative minimum taxable income instead of taxable income. Under paragraph (d)(2)(i)(B) of this section, for purposes of the apportionment of

interest expense in determining alternative minimum taxable income within each limitation category, Z is not considered a member of the XY affiliated group. Thus, the stock (and not the assets) of Z are included in computing the group apportionment fractions. Pursuant to sections 59(g)(4)(C)(iii)(IV), 861(a)(2)(A), and 862(a)(2), dividends paid by a section 936 corporation are foreign source income subject to a separate foreign tax credit limitation for alternative minimum tax purposes. Thus, under §1.861–9T(g)(3), the stock of Z must be considered attributable solely to the statutory grouping consisting of foreign source dividends from Z. The effect of excluding Z from the affiliated group is that X must apportion a part of its interest expense to the separate category for foreign source dividends from Z in computing alternative minimum taxable income within each separate category. If, as a result, under section 904(f), X has a separate limitation loss or an overall foreign loss in the category for dividends from Z for alternative minimum tax purposes, then that loss must be allocated against X's other income (separate limitation or United States source, as the case may be). The loss must be recaptured in subsequent years under the rules of section 904(f) for purposes of the alternative minimum tax foreign tax credit. * * *

(iv) *Effective date.* This paragraph (d)(2) applies to taxable years beginning after December 31, 1989.

(d)(3) through (6)(i) [Reserved]. For further guidance see §1.861–11T(d)(3) through (6)(i).

(ii) Any foreign corporation if more than 50 percent of the gross income of such foreign corporation for the taxable year is effectively connected with the conduct of a trade or business within the United States and at least 80 percent of either the vote or value of all outstanding stock of such foreign corporation is owned directly or indirectly by members of the affiliated group (determined with regard to this sentence). This paragraph (d)(6)(ii) applies to taxable years beginning on or after *July 16, 2014*. See 26 CFR 1.861–11T(d)(6)(ii) (revised as of April 1, 2014) for rules applicable to taxable years beginning after August 10, 2010, and before *July 16, 2014*. See 26 CFR 1.861–11T(d)(6)(ii) (revised as of April 1, 2010) for rules applicable to taxable years beginning on or before August 10, 2010.

(7) *Special rules for the application of §1.861–11T(d)(6).* The attribution rules of section 1563(e) and the regulations under that section shall apply in determining indirect ownership under §1.861–11T(d)(6). The Commissioner shall have the authority to disregard trusts, partnerships, and pass-through entities that break affiliated status. Corporations described in §1.861–11T(d)(6) shall be considered to constitute members of an affiliated group that does not file a consolidated return and shall therefore be subject to the limitations imposed under §1.861–11T(g). The affiliated group filing a consolidated return shall be considered to constitute a single corporation for purposes of applying the rules of §1.861–11T(g). For taxable years beginning after December 31, 1989, §1.861–11T(d)(6)(i) shall not apply in determining foreign source alternative minimum taxable income within each separate category and the alternative minimum tax foreign tax credit pursuant to section 59(a) to the extent that such application would result in the inclusion of a section 936 corporation within the affiliated group. This paragraph (d)(7) applies to taxable years beginning after December 31, 1986.

(e)–(g) [Reserved]. For further guidance, see §1.861–11T(e) through (g).

[T.D. 8916, 66 FR 273, Jan. 3, 2001, as amended by T.D. 9676, 79 FR 41426, July 16, 2014]

§1.861–11T Special rules for allocating and apportioning interest expense of an affiliated group of corporations (temporary).

(a) *In general.* Sections 1.861–9T, 1.861–10T, 1.861–12T, and 1.861–13T provide rules that are generally applicable in apportioning interest expense. The rules of this section relate to affiliated groups of corporations and implement section 864(e) (1) and (5), which requires affiliated group allocation and apportionment of interest expense. The rules of this section apply to taxable years beginning after December 31, 1986, except as otherwise provided in §1.861–13T. Paragraph (b) of this section describes the scope of the application of the rule for the allocation and apportionment of interest expense of affiliated groups of corporations, which is contained in paragraph (c) of this section. Paragraph (d) of this section sets

forth the definition of the term ''affiliated group'' for purposes of this section. Paragraph (e) describes the treatment of loans between members of an affiliated group. Paragraph (f) of this section provides rules concerning the affiliated group allocation and apportionment of interest expense in computing the combined taxable income of a FSC or DISC and its related supplier. Paragraph (g) of this section describes the treatment of losses caused by apportionment of interest expense in the case of an affiliated group that does not file a consolidated return.

(b) *Scope of application*—(1) *Application of section 864(e) (1) and (5) (concerning the definition and treatment of affiliated groups).* Section 864(e) (1) and (5) and the portions of this section implementing section 864(e) (1) and (5) apply to the computation of foreign source taxable income for purposes of section 904 (relating to various limitations on the foreign tax credit). Section 904 imposes separate foreign tax credit limitations on passive income, high withholding interest income, financial services income, shipping income, income consisting of dividends from each noncontrolled section 902 corporation, income consisting of dividends from a DISC or former DISC, taxable income attributable to foreign trade income within the meaning of section 923(b), distributions from a FSC or former FSC, and all other forms of foreign source income not enumerated above (''general limitation income''). Section 864(e) (1) and (5) and the portions of this section implementing section 864(e) (1) and (5) also apply in connection with section 907 to determine reductions in the amount allowed as a foreign tax credit under section 901. Section 864(e) (1) and (5) and the portions of this section implementing section 864(e) (1) and (5) also apply to the computation of the combined taxable income of the related supplier and a foreign sales corporation (FSC) (under sections 921 through 927) as well as the combined taxable income of the related supplier and a domestic international sales corporation (DISC) (under sections 991 through 997).

(2) *Nonapplication of section 864(e) (1) and (5) (concerning the definition and treatment of affiliated groups).* Section 864(e) (1) and (5) and the portions of this section implementing section 864(e) (1) and (5) do not apply to the computation of subpart F income of controlled foreign corporations (under sections 951 through 964), the computation of combined taxable income of a possessions corporation and its affiliates (under section 936), or the computation of effectively connected taxable income of foreign corporations. For the rules with respect to the allocation and apportionment of interest expenses of foreign corporations other than controlled foreign corporations, see §§ 1.882–4 and 1.882–5.

(c) *General rule for affiliated corporations.* Except as otherwise provided in this section, the taxable income of each member of an affiliated group within each statutory grouping shall be determined by allocating and apportioning the interest expense of each member according to apportionment fractions which are computed as if all members of such group were a single corporation. For purposes of determining these apportionment fractions, stock in corporations within the affiliated group (as defined in section 864(e)(5) and the rules of this section) shall not be taken into account. In the case of an affiliated group of corporations that files a consolidated return, consolidated foreign tax credit limitations are computed for the group in accordance with the rules of § 1.1502–4. Except as otherwise provided, all the interest expense of all members of the group will be treated as definitely related and therefore allocable to all the gross income of the members of the group and all the assets of all the members of the group shall be taken into account in apportioning this interest expense. For purposes of this section, the term ''taxpayer'' refers to the affiliated group (regardless of whether the group files a consolidated return), rather than to the separate members thereof.

(d)(1)–(2) [Reserved]. For further guidance, see § 1.861–11(d)(1) and (2).

(3) *Treatment of life insurance companies subject to taxation under section 801*—(i) *General rule.* A life insurance company that is subject to taxation under section 801 shall be considered to constitute a member of the affiliated

group composed of companies not taxable under section 801 only if a parent corporation so elects under section 1504(c)(2)(A) of the Code. If a parent does not so elect, no adjustments shall be required with respect to such an insurance company under paragraph (g) of this section.

(ii) *Treatment of stock.* Stock of a life insurance company that is subject to taxation under section 801 that is not included in an affiliated group shall be disregarded in the allocation and apportionment of the interest expense of such affiliated group.

(4) *Treatment of certain financial corporations*—(i) *In general.* In the case of an affiliated group (as defined in paragraph (d)(1) of this section), any member that constitutes financial corporations as defined in paragraph (d)(4)(ii) of this section shall be treated as a separate affiliated group consisting of financial corporations (the ''financial group''). The members of the group that do not constitute financial corporations shall be treated as members of a separate affiliated group consisting of nonfinancial corporations (''the nonfinancial group'').

(ii) *Financial corporation defined.* The term ''financial corporation'' means any corporation which meets all of the following conditions:

(A) It is described in section 581 (relating to the definition of a bank) or section 591 (relating to the deduction for dividends paid on deposits by mutual savings banks, cooperative banks, domestic building and loan associations, and other savings institutions chartered and supervised as savings and loan or similar associations);

(B) Its business is predominantly with persons other than related persons (within the meaning of section 864(d)(4) and the regulations thereunder) or their customers; and

(C) It is required by state or Federal law to be operated separately from any other entity which is not such an institution.

(iii) *Treatment of bank holding companies.* The total aggregate interest expense of any member of an affiliated group that constitutes a bank holding company subject to regulation under the Bank Holding Company Act of 1956 shall be prorated between the financial group and the nonfinancial group on the basis of the assets in the financial and nonfinancial groups. For purposes of making this proration, the assets of each member of each group, and not the stock basis in each member, shall be taken into account. Any direct or indirect subsidiary of a bank holding company that is predominantly engaged in the active conduct of a banking, financing, or similar business shall be considered to be a financial corporation for purposes of this paragraph (d)(4). The interest expense of the bank holding company must be further apportioned in accordance with §1.861–9T(f) to the various section 904(d) categories of income contained in both the financial group and the nonfinancial group on the basis of the assets owned by each group. For purposes of computing the apportionment fractions for each group, the assets owned directly by a bank holding company within each limitation category described in section 904(d)(1) (other than stock in affiliates or assets described in §1.861–9T(f)) shall be treated as owned pro rata by the nonfinancial group and the financial group based on the relative amounts of investments of the bank holding company in the nonfinancial group and financial group.

(iv) *Consideration of stock of the members of one group held by members of the other group.* In apportioning interest expense, the nonfinancial group shall not take into account the stock of any lower-tier corporation that is treated as a member of the financial group under paragraph (d)(4)(i) of this section. Conversely, in apportioning interest expense, the financial group shall not take into account the stock of any lower-tier corporation that is treated as a member of the nonfinancial group under paragraph (d)(4)(i) of this section. For the treatment of loans between members of the financial group and members of the nonfinancial group, see paragraph (e)(1) of this section.

(5) *Example.* (i) *Facts.* X, a domestic corporation which is not a bank holding company, is the parent of domestic corporations Y and Z. Z owns 100 percent of the stock Z1, which is also a domestic corporation. X, Y, Z, and Z1 were organized after January 1, 1987,

and constitute an affiliated group within the meaning of paragraph (d)(1) of this section. Y and Z are financial corporations described in paragraph (d)(4) of this section. X also owns 25 percent of the stock of A, a domestic corporation. Y owns 25 percent of the voting stock of B, a foreign corporation that is not a controlled foreign corporation. Z owns less than 10 percent of the voting stock of C, another foreign corporation. The foreign source income generated by Y's or Z's direct assets is exclusively financial services income. The foreign source income generated by X's or Z1's direct assets is exclusively general limitation income. X and Z1 are not financial corporations described in paragraph (d)(4)(ii) of this section. Y and Z, therefore, constitute a separate affiliated group apart from X and Z1 for purposes of section 864(e). The combined interest expense of Y and Z of $100,000 ($50,000 each) is apportioned separately on the basis of their assets. The combined interest expense of X and Z1 of $50,000 ($25,000 each) is allocated on the basis of the assets of the XZ1 group.

Analysis of the YZ group assets	
Adjusted basis of assets of the YZ group that generate foreign source financial services income (excluding stock of foreign subsidiaries not included in the YZ affiliated group)	$200,000
Z's basis in the C stock (not adjusted by the allocable amount of C's earnings and profits because Z owns less than 10 percent of the stock) which would be considered to generate passive income in the hands of a nonfinancial services entity but is considered to generate financial services income when in the hands of Z, a financial services entity	$100,000
Y's basis in the B stock (adjusted by the allocable amount of B's earnings and profits) which generates dividends subject to a separate limitation for B dividends	$100,000
Adjusted basis of assets of the YZ group that generate U.S. source income	$600,000
Total assets	$1,000,000
Analysis of the XZ1 group assets	
Adjusted basis of assets of the XZ1 group that generate foreign source general limitation income	$500,000
Adjusted basis of assets of the XZ1 group other than A stock that generate domestic source income	$1,900,000
X's basis in the A stock adjusted by the allocable amount of A's earnings and profits	$100,000
Total domestic assets	$2,000,000
Total assets	$2,500,000

(ii) *Allocation.* No portion of the $50,000 deduction of the YZ group is definitely related solely to specific property within the meaning of § 1.861–10T. Thus, the YZ group's deduction for interest is related to all its activities and properties. Similarly, no portion of the $50,000 deduction of the XZ1 group is definitely related solely to specific property within the meaning of § 1.861–10T. Thus, the XZ1 group's deduction for interest is related to all its activities and properties.

(iii) *Apportionment.* The YZ group would apportion its interest expense as follows:

To gross financial services income from sources outside the United States:

$$\$50,000 \times \frac{\$300,000}{\$1,000,000} \ldots\ldots \$15,000$$

To gross income subject to a separate limitation for dividends from B:

$$\$50,000 \times \frac{\$100,000}{\$1,000,000} \ldots\ldots \$5,000$$

To gross income from sources inside the United States:

$$\$50,000 \times \frac{\$600,000}{\$1,000,000} \ldots\ldots \$30,000$$

The XZ1 group would apportion its interest expense as follows:

To gross general limitation income from sources outside the United States:

$$\$50,000 \times \frac{\$500,000}{\$2,500,000} \ldots\ldots \$10,000$$

To gross income from sources inside the United States:

$$\$50,000 \times \frac{\$2,000,000}{\$2,500,000} \ldots\ldots \$40,000$$

(6) *Certain unaffiliated corporations.* Certain corporations that are not described in paragraph (d)(1) of this section will nonetheless be considered to constitute affiliated corporations for purposes of §§1.861–9T through 1.861–13T. These corporations include:

(i) Any includible corporation (as defined in section 1504(b) without regard to section 1504(b)(4)) if 80 percent of either the vote or value of all outstanding stock of such corporation is owned directly or indirectly by an includible corporation or by members of an affiliated group, and

(ii) [Reserved]. For further guidance see §1.861–11(d)(6)(ii).

(7) *Special rules for the application of §1.861–11T(d)(6).* [Reserved]. For special rules for the application of §1.861–11T(d)(6), see §1.861–11(d)(7).

(e) *Loans between members of an affiliated group*—(1) *General rule.* In the case of loans (including any receivable) between members of an affiliated group, as defined in paragraph (d) of this section, for purposes of apportioning interest expense, the indebtedness of the member borrower shall not be considered an asset of the member lender. However, in the case of members of separate financial and nonfinancial groups under paragraph (d)(4) of this section, the indebtedness of the member borrower shall be considered an asset of the member lender and such asset shall be characterized by reference to the member lender's income from the asset as determined under paragraph (e)(2)(ii) of this section. For purposes of this paragraph (e), the terms ''related person interest income'' and ''related person interest payment'' refer to interest paid and received by members of the same affiliated group as defined in paragraph (d) of this section.

(2) *Treatment of interest expense within the affiliated group*—(i) *General rule.* A member borrower shall deduct related person interest payments in the same manner as unrelated person interest expense using group apportionment fractions computed under §1.861–9T(f). A member lender shall include related person interest income in the same class of gross income as the class of gross income from which the member borrower deducts the related person interest payment.

(ii) *Special rule for loans between financial and nonfinancial affiliated corporations.* In the case of a loan between two affiliated corporations only one of which constitutes a financial corporation under paragraph (d)(4) of this section, the member borrower shall allocate and apportion related person interest payments in the same manner as unrelated person interest expense using group apportionment fractions computed under §1.861–9T(f). The source of the related person interest income to the member lender shall be determined under section 861(a)(1).

(iii) *Special rule for high withholding tax interest.* In the case of an affiliated corporation that pays interest that is high withholding tax interest under §1.904–5(f)(1) to another affiliated corporation, the interest expense of the payor shall be allocated to high withholding tax interest.

(3) *Back-to-back loans.* If a member of the affiliated group makes a loan to a nonmember who makes a loan to a member borrower, the rule of paragraphs (e) (1) and (2) of this section shall apply, in the Commissioner's discretion, as if the member lender made the loan directly to the member borrower, provided that the loans constitute a back-to-back loan transaction. Such loans will constitute a back-to-back loan for purposes of this paragraph (e) if the loan by the nonmember would not have been made or maintained on substantially the same terms irrespective of the loan of funds by the lending member to the nonmember or other intermediary party.

(4) *Examples.* The rules of this paragraph (e) may be illustrated by the following examples.

Example 1. X, a domestic corporation, is the parent of Y, a domestic corporation. X and Y were organized after January 1, 1987, and constitute an affiliated group within the meaning of paragraph (d)(1) of this section. Among X's assets is the note of Y for the amount of $100,000. Because X and Y are members of an affiliated group, Y's note does

not constitute an asset for purposes of apportionment. The apportionment fractions for the relevant tax year of the XY group are 50 percent domestic, 40 percent foreign general, and 10 percent foreign passive. Y deducts its related person interest payment using those apportionment fractions. Of the $10,000 in related person interest income received by X, $5,000 consists of domestic source income, $4,000 consists of foreign general limitation income, and $1,000 consists of foreign passive income.

Example 2. X is a domestic corporation organized after January 1, 1987. X owns all the stock of Y, a domestic corporation. On June 1, 1987, X loans $100,000 to Z, an unrelated person. On June 2, 1987, Z makes a loan to Y with terms substantially similar to those of the loan from X to Z. Based on the facts and circumstances of the transaction, it is determined that Z would not have made the loan to Y on the same terms if X had not made the loan to Z. Because the transaction constitutes a back-to-back loan, as defined in paragraph (e)(3) of this section, the Commissioner may require, in his discretion, that neither the note of Y nor the note of Z may be considered an asset of X for purposes of this section.

(f) *Computations of combined taxable income.* In the computation of the combined taxable income of any FSC or DISC and its related supplier which is a member of an affiliated group under the pricing rules of sections 925 or 994, the combined taxable income of such FSC or DISC and its related supplier shall be reduced by the portion of the total interest expense of the affiliated group that is incurred in connection with those assets of the group used in connection with export sales involving that FSC or DISC. This amount shall be computed by multiplying the total interest expense of the affiliated group and interest expense of the FSC or DISC by a fraction the numerator of which is the assets of the affiliated group and of the FSC or DISC generating foreign trade income or gross income attributable to qualified export receipts, as the case may be, and the denominator of which is the total assets of the affiliated group and the FSC or DISC. Under this rule, interest of other group members may be attributed to the combined taxable income of a FSC or DISC and its related supplier without affecting the amount of interest otherwise deductible by the FSC or DISC, the related supplier or other member of the affiliated group. The FSC or DISC is entitled to only the statutory portion of the combined taxable income, net of any deemed interest expense, which determines the commission paid to the FSC or DISC or the transfer price of qualifying export property sold to the FSC or DISC.

(g) *Losses created through apportionment*—(1) *General rules.* In the case of an affiliated group that is eligible to file, but does not file, a consolidated return and in the case of any corporation described in paragraph (d)(6) of this section, the foreign tax credits in any separate limitation category are limited to the credits computed under the rules of this paragraph (g). As a consequence of the affiliated group allocation and apportionment of interest expense required by section 864(e)(1) and this section, interest expense of a group member may be apportioned for section 904 purposes to a limitation category in which that member has no gross income, resulting in a loss in that limitation category. The same is true in connection with any expense other than interest that is subject to apportionment under the rules of section 864(e)(6) of the Code. Any reference to ''interest expense'' in this paragraph (g) shall be treated as including such expenses. For purposes of this paragraph, the term ''limitation category'' includes domestic source income, as well as the types of income described in section 904(d)(1) (A) through (I). A loss of one affiliate in a limitation category will reduce the income of another member in the same limitation category if a consolidated return is filed. (See §1.1502–4.) If a consolidated return is not filed, this netting does not occur. Accordingly, in such a case, the following adjustments among members are required in order to give effect to the group allocation of interest expense:

(i) Losses created through group apportionment of interest expense in one or more limitation categories within a given member must be eliminated; and

(ii) A corresponding amount of income of other members in the same limitation category must be recharacterized.

Such adjustments shall be accomplished, in accordance with paragraph (g)(2) of this section, without changing

the total taxable income of any member and before the application of section 904(f). Section 904(f) (including section 904(f)(5)) does not apply to a loss created through the apportionment of interest expense to the extent that the loss is eliminated pursuant to paragraph (g)(2)(ii) of this section. For purposes of this section, the terms ''limitation adjustment'' and ''recharacterization'' mean the recharacterization of income in one limitation category as income in another limitation category.

(2) *Mechanics of computation*—(i) *Step 1: Computation of consolidated taxable income*. The members of an affiliated group must first allocate and apportion all other deductible expenses other than interest. The members must then deduct from their respective gross incomes within each limitation category interest expense apportioned under the rules of §1.861–9T(f). The taxable income of the entire affiliated group within each limitation category is then totalled.

(ii) *Step 2: Loss offset adjustments*. If, after step 1, a member has losses in a given limitation category or limitation categories created through apportionment of interest expense, any such loss (*i.e.*, the portion of such loss equal to interest expense) shall be eliminated by offsetting that loss against taxable income in other limitation categories of that member to the extent of the taxable income of other members within the same limitation category as the loss. If the member has taxable income in more than one limitation category, then the loss shall offset taxable income in all such limitation categories on a pro rata basis. If there is insufficient domestic income of the member to offset the net losses in all foreign limitation categories caused by the apportionment of interest expense, the losses in each limitation category shall be recharacterized as domestic losses to the extent of the taxable income of other members in the same respective limitation categories. After these adjustments are made, the income of the entire affiliated group within each limitation category is totalled again.

(iii) *Step 3: Determination of amount subject to recharacterization*. In order to determine the amount of income to be recharacterized in step 4, the income totals computed under step 1 in each limitation category shall be subtracted from the income totals computed under step 2 in each limitation category.

(iv) *Step 4: Recharacterization*. Because any differences determined under step 3 represent deviations from the consolidated totals computed under Step 1, such differences (in any limitation category) must be eliminated.

(A) *Limitation categories to be reduced*. In the case of any limitation category in which there is a positive change, the income of group members with income in that limitation category must be reduced on a pro rata basis (by reference to net income figures as determined under Step 2) to the extent of such positive change (''limitation reductions''). Each member shall separately compute the sum of the limitation reductions.

(B) *Limitation categories to be increased*. In any case in which only one limitation category has a negative change in Step 3, the sum of the limitation reductions within each member is added to that limitation category. In the case in which multiple limitation categories have negative changes in Step 3, the sum of the limitation reductions within each member is prorated among the negative change limitation categories based on the ratio that the negative change for the entire group in each limitation category bears to the total of all negative changes for the entire group in all limitation categories.

(3) *Examples*. The following examples illustrate the principles of this paragraph.

Example 1. (i) *Facts*. X, a domestic corporation, is the parent of domestic corporations Y and Z. X, Y, and Z were organized after Janaury 1, 1987, constitute an affiliated group within the meaning of paragraph (d)(1) of this section, but do not file a consolidated return. The XYZ group apportions its interest expense on the basis of the fair market value of its assets. X, Y, and Z have the following assets, interest expense, and taxable income before apportioning interest expense:

Assets	X	Y	Z	Total
Domestic	2,000.00	0	1,000.00	3,000.00
Foreign Passive	0	50.00	50.00	100.00
Foreign General	0	700.00	200.00	900.00
Interest expense	48.00	12.00	80.00	140.00
Taxable Income (pre-interest):				
Domestic	100.00	0	63.00	163.00

Assets	X	Y	Z	Total
Foreign Passive	0	5.00	5.00	10.00
Foreign General	0	60.00	35.00	95.00

(ii) *Step 1: Computation of consolidated taxable income.* Each member of the XYZ group apportions its interest expense according to group apportionment ratios determined under the asset method decribed in §1.861–9T(f), yielding the following results:

Apportioned interest expense	X	Y	Z	Total
Domestic	36.00	9.00	60.00	105.00
Foreign Passive	1.20	0.30	2.00	3.50
Foreign General	10.80	2.70	18.00	31.50
Total	48.00	12.00	80.00	140.00

The members of the group then compute taxable income within each category by deducting the apportioned interest expense from the amounts of pre-interest taxable income specified in the facts in paragraph (i), yielding the following results:

Taxable income	X	Y	Z	Total
Domestic	64.00	9.00	3.00	58.00
Foreign Passive	−1.20	4.70	3.00	6.50
Foreign General	−10.80	57.30	17.00	63.50
Total	52.00	53.00	23.00	128.00

(iii) *Step 2: Loss offset adjustments.* Because X and Y have losses created through apportionment, these losses must be eliminated by reducing taxable income of the member in other limitation categories. Because X has a total of $12 in apportionment losses and because it has only one limitation category with income (*i.e.*, domestic), domestic income must be reduced by $12, thus eliminating its apportionment losses. Because Y has a total of $9 in apportionment losses and because it has two limitation categories with income (*i.e.*, foreign passive and foreign general limitation), the income in these two limitation categories must be reduced on a pro rata basis in order to eliminate its apportionment losses. In summary, the following adjustments are required:

Loss offset adjustments	X	Y	Z	Total
Domestic	−12.00	+ 9.00	0	−3.00
Foreign Passive	+ 1.20	−0.68	0	+ 0.52
Foreign General	+ 10.80	−8.32	0	+ 2.48

These adjustments yield the following adjusted taxable income figures:

Adjusted taxable income	X	Y	Z	Total
Domestic	52.00	0	3.00	55.00
Foreign Passive	0	4.02	3.00	7.02
Foreign General	0	48.98	17.00	65.98
Total	52.00	53.00	23.00	128.00

(iv) *Step 3: Determination of amount subject to recharacterization.* The adjustments performed under Step 2 led to a change in the group's taxable income within each limitation category. The total loss offset adjustments column shown in paragraph (iii) above shows the net deviations between Step 1 and 2.

(v) *Step 4: Recharacterization.* The loss offset adjustments yield a positive change in the foreign passive and the foreign general limitation categories. Y and Z both have income in these limitation categories. Accordingly, the income of Y and Z in each of these limitation categories must be reduced on a pro rata basis (by reference to the adjusted taxable income figures) to the extent of the positive change in each limitation category. The total positive change in the foreign passive limitation category is $0.52. The adjusted taxable income of Y in the foreign passive limitation category is $4.02 and the adjusted taxable income of Z in the foreign passive limitation category is $3. Therefore, $0.30 is drawn from Y and $0.22 is drawn from Z. The total positive change in the foreign general limitation category is $2.48. The adjusted taxable income of Y in the foreign general limitation category is $48.98, and the adjusted taxable income of Z in the foreign general limitation category is $17. Therefore, $1.84 is drawn from Y and $.64 is drawn from Z.

The members must then separately compute the sum of the limitation reductions. Y has limitation reductions of $0.30 in the foreign passive limitation category and $1.84 in the foreign general limitation category, yielding total limitation reduction of $2.14. Under these facts, domestic income is the only limitation category requiring a positive adjustment. Accordingly, Y's domestic income is increased by $2.14. Z has limitation reductions of $0.22 in the foreign passive limitation category and $0.64 in the foreign general limitation category, yielding total limitation reductions of $0.86. Under these facts, domestic income is the only limitation category of Z requiring a positive adjustment. Accordingly, Z's domestic income is increased by $0.86.

Recharacterization adjustments	X	Y	Z	Total
Domestic	0	+ 2.14	+ 0.86	+ 3.00
Foreign Passive	0	−0.30	−0.22	−0.52
Foreign General	0	−1.84	−0.64	−2.48

These recharacterization adjustments yield the following final taxable income figures:

Final taxable income	X	Y	Z	Total
Domestic	52.00	2.14	3.86	58.00
Foreign Passive	0	3.72	2.78	6.50
Foreign General	0	47.14	16.36	63.50
Total	52.00	53.00	23.00	128.00

Example 2. (i) *Facts.* X, a domestic corporation, is the parent of domestic corporations Y and Z. X, Y, and Z were organized after January 1, 1987, constitute an affiliated group within the meaning of paragraph (d)(1) of this section, but do not file a consolidated return. Moreover, X has served as the sole borrower in the group and, as a result, has sustained an overall loss. The XYZ group apportions its interest expense on the basis of the fair market value of its assets. X, Y, and Z have the following assets, interest expense, and taxable income before interest expense:

Assets	X	Y	Z	Total
Domestic	2,000	0	1,000	3,000
Foreign Passive	0	50	50	100
Foreign General	0	700	200	900
Interest Expense	140	0	0	140
Taxable Income (pre-interest):				
Domestic	100	0	100	200
Foreign Passive	0	5	5	10
Foreign General	0	70	35	105

(ii) *Step 1: Computation of consolidated taxable income.* Each member of the XYZ group apportions its interest expense according to group apportionment ratios determined under the asset method described in §1.861–9T(g), yielding the following results:

Apportioned interest expense	X	Y	Z	Total
Domestic	105.00	0	0	105.00
Foreign Passive	3.50	0	0	3.50
Foreign General	31.50	0	0	31.50
Total	140.00	0	0	140.00

The members of the group then compute taxable income within each category by deducting the apportioned interest expense from the amounts of pre-interest taxable income specified in the facts in paragraph (i), yielding the following results:

Taxable income	X	Y	Z	Total
Domestic	−5.00	0	100.00	95.00
Foreign Passive	−3.50	5.00	5.00	6.50
Foreign General	−31.50	70.00	35.00	73.50
Total	−40.00	75.00	140.00	175.00

(iii) *Step 2: Loss offset adjustment.* Because X has insufficient domestic income to offset the sum of the losses in the foreign limitation categories caused by apportionment, the amount of apportionment losses in each limitation category shall be recharacterized as domestic losses to the extent of taxable income of other members in the same limitation category. This is accomplished by adding to each foreign limitation categories an amount equal to the loss therein and by subtracting the sum of such foreign losses from domestic income, as follows:

Loss offset adjustments	X	Y	Z	Total
Domestic	−35.00	0	0	−35.00
Foreign Passive	+ 3.50	0	0	+ 3.50
Foreign General	+ 31.50	0	0	+ 31.50

These adjustments yield the following adjusted taxable income figures:

Adjusted taxable income	X	Y	Z	Total
Domestic	−40	0	100	60
Foreign Passive	0	5	5	10
Foreign General	0	70	35	105
Total	−40	75	140	175

(iv) *Step 3: Determination of amount subject to recharacterization.* The adjustments performed under Step 2 led to a change in the group's taxable income within each limitation category. The total loss offset adjustment column shown in paragraph (iii) above shows the net deviations between Steps 1 and 2.

(v) *Step 4: Recharacterization.* The loss offset adjustments yield a positive change in the foreign passive and the foreign general limitation categories. Y and Z both have income in these limitation categories. Accordingly, the income of Y and Z in each of these limitation categories must be reduced on a pro rata basis (by reference to the adjusted taxable income figures) to the extent of the positive change in each limitation category. The total positive change in the foreign passive limitation category is $3.50. The adjusted taxable income of Y in the foreign passive limitation category is $5, and the adjusted taxable income of Z in the foreign passive limitation category is $5. Therefore, $1.75 is drawn from Y and $1.75 is drawn from Z. The total positive change in the foreign general limitation category is $31.50. The adjusted taxable income of Y in the foreign general limitation category is $70, and the adjusted taxable income of Z in the foreign general limitation category is $35. Therefore, $21 is drawn from Y and $10.50 is drawn from Z.

The members must then separately compute the sum of the limitation reductions. Y has limitation reductions of $1.75 in the foreign passive limitation category and $21 in the foreign general limitation category, yielding total limitation reductions of $22.75. Under these facts, domestic income is the only limitation category requiring a positive

adjustment. Accordingly, Y's domestic income is increased by $22.75. Z has limitation reductions of $1.75 in the foreign passive limitation category and $10.50 in the foreign general limitation category, yielding total limitation reductions of $12.25. Under these facts, domestic income is the only limitation category requiring a positive adjustment. Accordingly, Z's domestic income is increased by $12.25.

Recharacterization adjustments	X	Y	Z	Total
Domestic	0	+ 22.75	+ 12.25	+ 35.00
Foreign Passive	0	− 1.75	− 1.75	− 3.50
Foreign General	0	− 21.00	− 10.50	− 31.50

These recharacterization adjustments yield the following final taxable income figures:

Final taxable income	X	Y	Z	Total
Domestic	− 40.00	22.75	112.25	95.00
Foreign Passive	0	3.25	3.25	6.50
Foreign General	0	49.00	24.50	73.50
Total	− 40.00	75.00	140.00	175.00

(h) *Effective/applicability date.* In general, the rules of this section apply for taxable years beginning after December 31, 1986.

[T.D. 8228, 53 FR 35490, Sept. 14, 1988, as amended by T.D. 8916, 65 FR 274, Jan. 3, 2001; T.D. 9456, 74 FR 38875, Aug. 4, 2009; T.D. 9571, 77 FR 2227, Jan. 17, 2012; 77 FR 9844, Feb. 21, 2012; T.D. 9676, 79 FR 41426, July 16, 2014]

§ 1.861–12 Characterization rules and adjustments for certain assets.

(a) through (c)(1) [Reserved] For further guidance, *see* § 1.861–12T(a) through (c)(1).

(2) *Basis adjustment for stock in nonaffiliated 10 percent owned corporations*—(i) *Taxpayers using the tax book value method*—(A) *General rule.* For purposes of apportioning expenses on the basis of the tax book value of assets, the adjusted basis of any stock in a 10 percent owned corporation owned by the taxpayer either directly or, for taxable years beginning after April 25, 2006, indirectly through a partnership or other pass-through entity shall be—

(*1*) Increased by the amount of the earnings and profits of such corporation (and of lower-tier 10 percent owned corporations) attributable to such stock and accumulated during the period the taxpayer or other members of its affiliated group held 10 percent or more of such stock; or

(*2*) Reduced (but not below zero) by any deficit in earnings and profits of such corporation (and of lower-tier 10 percent owned corporations) attributable to such stock for such period.

(c)(2)(i)(B) through (c)(3) [Reserved] For further guidance, *see* § 1.861–12T(c)(2)(i)(B) through (c)(3).

(4) *Characterization of stock of noncontrolled section 902 corporations*—(i) *General rule.* The principles of § 1.861–12T(c)(3) shall apply to stock in a noncontrolled section 902 corporation (as defined in section 904(d)(2)(E)). Accordingly, stock in a noncontrolled section 902 corporation shall be characterized as an asset in the various separate limitation categories on the basis of either the asset method described in § 1.861–12T(c)(3)(ii) or the modified gross income method described in § 1.861–12T(c)(3)(iii). Stock in a noncontrolled section 902 corporation the interest expense of which is apportioned on the basis of assets shall be characterized in the hands of its domestic shareholders (as defined in § 1.902–1(a)(1)) under the asset method described in § 1.861–12T(c)(3)(ii). Stock in a noncontrolled section 902 corporation the interest expense of which is apportioned on the basis of gross income shall be characterized in the hands of its domestic shareholders under the gross income method described in § 1.861–12T(c)(3)(iii).

(ii) *Nonqualifying shareholders.* Stock in a noncontrolled section 902 corporation shall be characterized as a passive category asset in the hands of a shareholder that is not eligible to compute an amount of foreign taxes deemed paid with respect to a dividend from the noncontrolled section 902 corporation for the taxable year, and in the hands of any shareholder with respect to whom look-through treatment is not substantiated. *See* § 1.904–5(c)(4)(iii).

(5) *Effective/applicability date.* Paragraphs (c)(2)(i)(A) and (4) of this section apply to taxable years of shareholders ending on or after April 20, 2009. *See* 26 CFR § 1.861–12T(c)(2)(i) introductory text, (2)(i)(A), (2)(i)(B), and (4) (revised as of April 1, 2009) for rules applicable to taxable years of shareholders ending after the first day of the

first taxable year of the noncontrolled section 902 corporation beginning after December 31, 2002, and ending before April 20, 2009.

(d) through (j) [Reserved] For further guidance, *see* § 1.861–12T(d) through (j).

[T.D. 9452, 74 FR 27874, June 11, 2009]

§ 1.861–12T Characterization rules and adjustments for certain assets (temporary).

(a) *In general.* These rules are applicable to taxpayers in apportioning expenses under an asset method to income in various separate limitation categories under section 904(d), and supplement other rules provided in §§ 1.861–9T, 1.861–10T, and 1.861–11T. The rules of this section apply to taxable years beginning after December 31, 1986, except as otherwise provided in § 1.861–13T. Paragraph (b) of this section describes the treatment of inventories. Paragraph (c)(1) of this section concerns the treatment of various stock assets. Paragraph (c)(2) of this section describes a basis adjustment for stock in nonaffiliated 10 percent owned corporations. Paragraph (c)(3) of this section sets forth rules for characterizing the stock in controlled foreign corporations. Paragraph (c)(4) of this section describes the treatment of stock of noncontrolled section 902 corporations. Paragraph (d)(1) of this section concerns the treatment of notes. Paragraph (d)(2) of this section concerns the treatment of the notes of controlled foreign corporations. Paragraph (e) of this section describes the treatment of certain portfolio securities that constitute inventory or generate income primarily in the form of gains. Paragraph (f) of this section describes the treatment of assets that are subject to the capitalization rules of section 263A. Paragraph (g) of this section concerns the treatment of FSC stock and of assets of the related supplier generating foreign trade income. Paragraph (h) of this section concerns the treatment of DISC stock and of assets of the related supplier generating qualified export receipts. Paragraph (i) of this section is reserved. Paragraph (j) of this section sets forth an example illustrating the rules of this section, as well as the rules of § 1.861–9T(g).

(b) *Inventories.* Inventory must be characterized by reference to the source and character of sales income, or sales receipts in the case of LIFO inventory, from that inventory during the taxable year. If a taxpayer maintains separate inventories for any federal tax purpose, including the rules for establishing pools of inventory items under sections 472 and 474 of the Code, each separate inventory shall be separately characterized in accordance with the previous sentence.

(c) *Treatment of stock*—(1) *In general.* Subject to the adjustment and special rules of paragraphs (c) and (e) of this section, stock in a corporation is taken into account in the application of the asset method described in § 1.861–9T(g). However, an affiliated group (as defined in § 1.861–11T(d)) does not take into account the stock of any member in the application of the asset method.

(2) *Basis adjustment for stock in nonaffiliated 10 percent owned corporations*—

(i)(A) [Reserved] For further guidance, *see* § 1.861–12(c)(2)(i)(A).

(B) *Computational rules.* Solely for purposes of this section, a taxpayer's basis in the stock of a controlled foreign corporation shall not include any amount included in basis under section 961 or 1293(d) of the Code. For purposes of this paragraph (c)(2), earnings and profits and deficits are computed under the rules of section 312 and, in the case of a foreign corporation, section 902 and the regulations thereunder for taxable years of the 10 percent owned corporation ending on or before the close of the taxable year of the taxpayer. The rules of section 1248 and the regulations thereunder shall apply to determine the amount of earnings and profits that is attributable to stock without regard to whether earned and profits (or deficits) were derived (or incurred) during taxable years beginning before or after December 31, 1962. This adjustment is to be made annually and is noncumulative. Thus, the adjusted basis of the stock (determined without prior years' adjustments under this section) is to be adjusted annually by the amount of accumulated earnings and profits (or any deficit) attributable to such stock as of the end of each year. Earnings and profits or deficits of a qualified business unit that has a

functional currency other than the dollar must be computed under this paragraph (c)(2) in functional currency and translated into dollars using the exchange rate at the end of the taxpayer's current taxable year with respect to which interest is being allocated (and not the exchange rates for the years in which the earnings and profits or deficits were derived or incurred).

(ii) *10 percent owned corporation defined*—(A) *In general.* The term ''10 percent owned corporation'' means any corporation (domestic or foreign)—

(*1*) Which is not included within the taxpayer's affiliated group as defined in § 1.861–11T(d) (1) or (6).

(*2*) In which the members of the taxpayer's affiliated group own directly or indirectly 10 percent or more of the total combined voting power of all classes of the stock entitled to vote, and

(*3*) Which is taken into account for purposes of apportionment.

(B) *Rule of attribution.* Stock that is owned by a corporation, partnership, or trust shall be treated as being indirectly owned proportionately by its shareholders, partners, or beneficiaries. For this purpose, a partner's interest in stock held by a partnership shall be determined by reference to the partner's distributive share of partnership income.

(iii) *Earnings and profits of lower-tier corporations taken into account.* For purposes of the adjustment to the basis of the stock of the 10 percent owned corporation owned by the taxpayer under paragraph (c)(2)(i) of this section, the earnings and profits of that corporation shall include its pro rata share of the earnings and profits (or any deficit therein) of each succeeding lower-tier 10 percent owned corporation. Thus, a first-tier 10 percent owned corporation shall combine with its own earnings and profits its pro rata share of the earnings and profits of all such lower-tier corporations. The affiliated group shall then adjust its basis in the stock of the first-tier corporation by its pro rata share of the total combined earnings and profits of the first-tier and the lower-tier corporations. In the case of a 10 percent owned corporation whose tax year does not conform to that of the taxpayer, the taxpayer shall include the annual earnings and profits of such 10 percent owned corporation for the tax year ending within the tax year of the taxpayer, whether or not such 10 percent owned corporation is owned directly by the taxpayer.

(iv) *Special rules for foreign corporations in pre-effective date tax years.* Solely for purposes of determining the adjustment required under paragraph (c)(2)(i) of this section, for tax years beginning after 1912 and before 1987, financial earnings (or losses) of a foreign corporation computed using United States generally accepted accounting principles may be substituted for earnings and profits in making the adjustment required by paragraph (c)(2)(i) of this section. A taxpayer is not required to isolate the financial earnings of a foreign corporation derived or incurred during its period of 10 percent ownership or during the post-1912 taxable years and determine earnings and profits (or deficits) attributable under section 1248 principles to the taxpayer's stock in a 10 percent owned corporation. Instead, the taxpayer may include all historic financial earnings for purposes of this adjustment. If the affiliated group elects to use financial earnings with respect to any foreign corporation, financial earnings must be used by that group with respect to all foreign corporations, except that earnings and profits may in any event be used for controlled foreign corporations for taxable years beginning after 1962 and before 1987. However, if the affiliated group elects to use earnings and profits with respect to any single controlled foreign corporation for the 1963 through 1986 period, such election shall apply with respect to all its controlled foreign corporations.

(v) *Taxpayers using the fair market value method.* Because the fair market value of any asset which is stock will reflect retained earnings and profits, taxpayers who use the fair market value method shall not adjust stock basis by the amount of retained earnings and profits, as otherwise required by paragraph (c)(2)(i) of this section.

(vi) *Examples.* Certain of the rules of this paragraph (c)(2) may be illustrated by the following examples.

Example 1. X, an affiliated group that uses the tax book value method of apportionment, owns 20 percent of the stock of Y, which owns 50 percent of the stock of Z. X's basis in the Y stock is $1,000. X, Y, and Z have calendar taxable years. The undistributed earnings and profits of Y and Z at year-end attributable to X's period of ownership are $80 and $40, respectively. Because Y owns half of the Z stock, X's pro rata share of Z's earnings and profits attributable to X's Y stock is $4. X's pro rata share of Y's earnings attributable to X's Y stock is $16. For purposes of apportionment, the tax book value of the Y stock is, therefore, considered to be $1,020.

Example 2. X, an unaffiliated domestic corporation that was organized on January 1, 1987, has owned all the stock of Y, a foreign corporation with a functional currency other than the U.S. dollar, since January 1, 1987. Both X and Y have calendar taxable years. All of Y's assets generate general limitation income. X has a deductible interest expense incurred in 1987 of $160,000. X apportions its interest expense using the tax book value method. The adjusted basis of its assets that generate domestic income is $7,500,000. The adjusted basis of its assets that generate foreign source general limitation income (other than the stock of Y) is $400,000. X's adjusted basis in the Y stock is $2,000,000. Y has undistributed earnings and profits for 1987 of $100,000, translated into dollars from Y's functional currency at the exchange rate on the last day of X's taxable year. Because X is required under paragraph (b)(1) of this § 1.861–10T to increase its basis in the Y stock by the computed amount of earnings and profits, X's adjusted basis in the Y stock is considered to be $2,100,000, and its adjusted basis of assets that generate foreign source general limitation income is, thus, considered to be $2,500,000. X would apportion its interest expense as follows:

To foreign source general limitation income:

$$\text{Interest expense} \times \frac{\text{Adjusted basis of foreign general limitation assets}}{\text{Adjusted basis of foreign general limitation assets} + \text{Adjusted basis of domestic assets}}$$

$$\$160{,}000 \times \frac{\$2{,}500{,}000}{\$2{,}500{,}000 + \$7{,}500{,}000} = \$40{,}000$$

To domestic source income:

$$\text{Interest expense} \times \frac{\text{Adjusted basis of domestic assets}}{\text{Adjusted basis of foreign general limitation assets} + \text{Adjusted basis of domestic assets}}$$

$$\$160{,}000 \times \frac{\$7{,}500{,}000}{\$2{,}500{,}000 + \$7{,}500{,}000} = \$120{,}000$$

(3) *Characterization of stock of controlled foreign corporations*—(i) *In general.* Stock in a controlled foreign corporation (as defined in section 957) shall be characterized as an asset in the various separate limitation categories either on the basis of:

(A) The asset method described in paragraph (c)(3)(ii) of this section, or

(B) The modified gross income method described in paragraph (c)(3)(iii) of this section.

Stock in a controlled foreign corporation whose interest expense is apportioned on the basis of assets shall be characterized in the hands of its United States shareholders under the asset method described in paragraph (c)(3)(ii). Stock in a controlled foreign corporation whose interest expense is

apportioned on the basis of gross income shall be characterized in the hands of its United States shareholders under the gross income method described in paragraph (c)(3)(iii).

(ii) *Asset method*. Under the asset method, the taxpayer characterizes the tax book value or fair market value of the stock of a controlled foreign corporation based on an analysis of the assets owned by the controlled foreign corporation during the foreign corporation's taxable year that ends with or within the taxpayer's taxable year. This process is based on the application of § 1.861–9T(g) at the level of the controlled foreign corporation. In the case of a controlled foreign corporation that owns stock in one or more lower-tier controlled foreign corporations in which the United States taxpayer is a United States shareholder, the characterization of the tax book value of the fair market value of the stock of the first-tier controlled foreign corporation to the various separate limitation categories of the affiliated group must take into account the stock in lower-tier corporations. For this purpose, the stock of each such lower-tier corporation shall be characterized by reference to the assets owned during the lower-tier corporation's taxable year that ends during the taxpayer's taxable year. The analysis of assets within a chain of controlled foreign corporations must begin at the lowest-tier controlled foreign corporation and proceed up the chain to the first-tier controlled foreign corporation. For purposes of this paragraph (c), the value of any passive asset to which related person interest is allocated under § 1.904–5(c)(2)(ii) must be reduced by the principal amount of indebtedness on which such interest is incurred. Furthermore, the value of any asset to which interest expense is directly allocated under § 1.861–10T must be reduced as provided in § 1.861–9T(g)(2)(iii). See § 1.861–9T(h)(5) for further guidance concerning characterization of stock in a related person under the fair market value method.

(iii) *Modified gross income method*. Under the gross income method, the taxpayer characterizes the tax book value of the stock of the first-tier controlled foreign corporation based on the gross income net of interest expense of the controlled foreign corporation (as computed under § 1.861–9T(j)) within each relevant category for the taxable year of the controlled foreign corporation ending with or within the taxable year of the taxpayer. For this purpose, however, the gross income of the first-tier controlled foreign corporation shall include the total amount of net subpart F income of any lower-tier controlled foreign corporation that was excluded under the rules of § 1.861–9T(j)(2)(ii)(B).

(4) [Reserved] For further guidance, *see* § 1.861–12(c)(4).

(5) [Reserved] For further guidance, *see* § 1.861–12(c)(5).

(d) *Treatment of notes*—(1) *General rule*. Subject to the adjustments and special rules of this paragraph (d) and paragraph (e) of this section, all notes held by a taxpayer are taken into account in the application of the asset method described in § 1.861–9T(g). However, the notes of an affiliated corporation are subject to special rules set forth in § 1.861–11T(e). For purposes of this section, the term ''notes'' means all interest bearing debt, including debt bearing original issue discount.

(2) *Characterization of related controlled foreign corporation notes*. The debt of a controlled foreign corporation shall be characterized according to the taxpayer's treatment of the interest income derived from that debt obligation after application of the look-through rule of section 904(d)(3)(C). Thus, a United States shareholder includes interest income from a controlled foreign corporation in the same category of income as the category of income from which the controlled foreign corporation deducts the interest expense. See section 954(b)(5) and § 1.904–5(c)(2) for rules concerning the allocation of related person interest payments to the foreign personal holding company income of a controlled foreign corporation.

(e) *Portfolio securities that constitute inventory or generate primarily gains*. Because gain on the sale of securities is sourced by reference to the residence of the seller, a resident of the United States will generally receive domestic source income (and a foreign resident will generally receive foreign source

income) upon sale or disposition of securities that otherwise generate foreign source dividends and interest (or domestic source dividends and interest in the case of a foreign resident). Although under paragraphs (c) and (d) of this section securities are characterized by reference to the source and character of dividends and interest, the source and character of income on gain or disposition must also be taken into account for purposes of characterizing portfolio securities if:

(1) The securities constitute inventory in the hands of the holder, or

(2) 80 percent or more of the gross income generated by a taxpayer's entire portfolio of such securities during a taxable year consists of gains.

For this purpose, a portfolio security is a security in any entity other than a controlled foreign corporation with respect to which the taxpayer is a United States shareholder under section 957, a noncontrolled section 902 corporation with respect to the taxpayer, or a 10 percent owned corporation as defined in §1.861–12(c)(2)(ii). In taking gains into account, a taxpayer must treat all portfolio securities generating foreign source dividends and interest as a single asset and all portfolio securities generating domestic source dividends as a single asset and shall characterize the total value of that asset based on the source of all income and gain generated by those securities in the taxable year.

(f) *Assets funded by disallowed interest*—(1) *Rule*. In the case of any asset in connection with which interest expense accruing at the end of the taxable year is capitalized, deferred, or disallowed under any provision of the Code, the adjusted basis or fair market value (depending on the taxpayer's choice of apportionment methods) of such an asset shall be reduced by the principal amount of indebtedness the interest on which is so capitalized, deferred, or disallowed.

(2) *Example*. The rules of this paragraph (f) may be illustrated by the following example.

Example. X is a domestic corporation which uses the tax book value method of apportionment. X has $1000 of indebtedness and $100 of interest expense. X constructs an asset with an adjusted basis of $800 before interest capitalization and is required under the rules of section 263A to capitalize $80 in interest expense. Because interest on $800 of debt is capitalized and because the production period is in progress at the end of X's taxable year, $800 of the principal amount of X's debt is allocable to the building. The $800 of debt allocable to the building reduces its adjusted basis for purposes of apportioning the balance of X's interest expense ($20).

(g) *Special rules for FSCs*—(1) *Treatment of FSC stock*. No interest expense shall be allocated or apportioned to stock of a foreign sales corporation (''FSC'') to the extent that the FSC stock is attributable to the separate limitation for certain FSC distributions described in section 904(d)(1)(H). FSC stock is considered to be attributable solely to the separate limitation category described in section 904(d)(1)(H) unless the taxpayer can demonstrate that more than 20 percent of the FSC's gross income for the taxable year consists of income other than foreign trading income.

(2) *Treatment of assets that generate foreign trade income*. Assets of the related supplier that generate foreign trade income must be prorated between assets attributable to foreign source general limitation income and assets attributable to domestic source income in proportion to foreign source general limitation income and domestic source income derived from transactions generating foreign trade income.

(i) *Value of assets attributable to foreign source income*. The value of assets attributable to foreign source general limitation income is computed by multiplying the value of assets for the taxable year generating foreign trading gross receipts by a fraction:

(A) The numerator of which is foreign source general limitation income for the taxable year derived from transactions giving rise to foreign trading gross receipts, after the application of the limitation provided in section 927(e)(1), and

(B) The denominator of which is total income for the taxable year derived from the transaction giving rise to foreign trading gross receipts.

(ii) *Value of assets attributable to domestic source income*. The value of assets attributable to domestic source income is computed by subtracting from the total value of assets for the taxable

year generating foreign trading gross receipts the value of assets attributable to foreign source general limitation income as computed under paragraph (g)(2)(i) of this section.

(h) *Special rules for DISCs*—(1) *Treatment of DISC stock*. No interest shall be allocated or apportioned to stock in a DISC (or stock in a former DISC to the extent that the stock in the former DISC is attributable to the separate limitation category described in section 904(d)(1)(F)).

(2) *Treatment of assets that generate qualified export receipts*. Assets of the related supplier that generate qualified export receipts must be prorated between assets attributable to foreign source general limitation income and assets attributable to domestic source income in proportion to foreign source general limitation income and domestic source income derived from transactions during the taxable year from transactions generating qualified export receipts.

(i) [Reserved]

(j) *Examples*. Certain of the rules in this section and §§ 1.861–9T(g) and 1.861–10(e) are illustrated by the following example.

Example 1. (1) *Facts*. X, a domestic corporation organized on January 1, 1987, has a calendar taxable year and apportions its interest expense on the basis of the tax book value of its assets. In 1987, X incurred a deductible third-party interest expense of $100,000 on an average month-end debt amount of $1 million. The total tax book value of X's assets (adjusted as required under paragraph (b) of this section for retained earnings and profits) is $2 million. X manufactures widgets. One-half of the widgets are sold in the United States and one-half are exported and sold through a foreign branch with title passing outside the United States.

X owns all the stock of Y, a controlled foreign corporation that also has a calendar taxable year and is also engaged in the manufacture and sale of widgets. Y has no earnings and profits or deficits in earnings and profits prior to 1987. For 1987, Y has taxable income and earnings and profits of $50,000 before the deductible for related person interest expense. Half of the $50,000 is foreign source personal holding company income and the other half is derived from widget sales and constitutes foreign source general limitation income. Assume that Y has no deductibles from gross income other than interest expense. Y's foreign personal holding company taxable income is included in X's gross income under section 951. Y paid no dividends in 1987. Prior to 1987, Y did not borrow any funds from X. The average month-end level of borrowings by Y from X in 1987 is $100,000, on which Y paid a total of $10,000 in interest. The total tax book value of Y's assets in 1987 is $500,000. Y has no liabilities to third parties. X elects pursuant to § 1.861–9T for Y to apportion Y's interest expense under the gross income method prescribed in § 1.861–9T(g).

In addition to its stock in Y, X owns 20 percent of the stock of Z, a noncontrolled section 902 corporation.

X's total assets and their tax book values are:

Asset	Tax book value
Plant & equipment	$1,000,000
Corporate headquarters	500,000
Inventory	200,000
Automobiles	20,000
Patents	50,000
Trademarks	10,000
Y stock (including paragraph (c)(2) adjustment)	80,000
Y note	100,000
Z stock	40,000

(2) *Categorization of Assets*.

Single Category Assets

1. Automobiles: X's automobiles are used exclusively by its domestic sales force in the generation of United States source income. Thus, these assets are attributable solely to the grouping of domestic income.

2. Y Note: Under paragraph (d)(2) of this section, the Y note in the hands of X is characterized according to X's treatment of the interest income received on the Y note. In determining the source and character of the interest income on the Y note, the look-through rules of sections 904(d)(3)(C) and 904(g) apply. Under section 954(b)(5) and § 1.904–5(c)(2)(ii), Y's $10,000 interest payment to X is allocated directly to, and thus reduces, Y's foreign personal holding company income of $25,000 (yielding foregin personal holding company taxable income of $15,000). Therefore, the Y note is attributable solely to the statutory grouping of foreign source passive income.

3. Z stock: Because Z is a noncontrolled section 902 corporation, the dividends paid by Z are subject to a separate limitation under section 904(d)(1)(E). Thus, this asset is attributable solely to the statutory grouping consisting of Z dividends.

Multiple Category Assets

1. Plant & equipment, inventory, patents, and trademarks: In 1987, X sold half its widgets in the United States and exported half outside the United States. A portion of the

taxable income from export sales will be foreign source income, since the export sales were accomplished through a foreign branch and title passed outside the United States. Thus, these assets are attributable both to the statutory grouping of foreign general limitation and the grouping of domestic income.

2. Y Stock: Since Y's interest expense is apportioned under the gross income method prescribed in §1.861–9T(j), the Y stock must be characterized under the gross income method described in paragraph (c)(3)(iii) of this section.

Assets without Directly Identifiable Yield

1. Corporate headquarters: This asset generates no directly identifiable income yield. The value of the asset is disregarded.

(3) *Analysis of Income Yield for Multiple Category Assets.*

1. Plant & Equipment, inventory, patents, and trademarks: As noted above, X's 1987 widget sales were half domestic and half foreign. Assume that Example 2 of §1.863–3(b)(2) applies in sourcing the export income from the export sales. Under Example 2, the income generated by the export sales is sourced half domestic and half foreign. The income gnerated by the domestic sales is entirely domestic source. Accordingly, three-quarters of the income generated on all sales is domestic source and one-quarter of the income is foreign source. Thus, three-quarters of the fair market value of these assets are attributed to the grouping of domestic source income and one-quarter of the fair market value of these assets is attributed to the statutory grouping of foreign source general limitation income.

2. Y Stock: Under the gross income method described in paragraph (c)(3)(iii) of this section, Y's gross income net of interest expenses in each limitation category must be determined—$25,000 foreign source general limitation income and $15,000 of foreign source passive income. Of X's adjusted basis of $80,000 in Y stock, $50,000 is attributable to foreign source general limitation income and $30,000 is attributable to foreign source passive income.

(4) *Application of the Special Allocation Rule of §1.861–10T(e).* Assume that the taxable year in question is 1990 and that the appliable percentage prescribed by §1.861–10T(e)(1)(iv)(A) is 80 percent. Assume that X has elected to use the quadratic formula provided in §1.861–10T(e)(1)(iv)(B).

Step 1. X's average month-end level of debt owning to unrelated persons is $1 million. The tax book value of X's assets is $2 million. Thus, X's debt-to-asset ratio computed under §1.861–10T(e)(1)(i) is 1 to 2.

Step 2. The tax book value of Y's assets is $500,000. Because Y has no debt to persons other than X, Y's debt-to-asset ratio computed under §1.861–10T(e)(1)(ii) is $0 to $500,000.

Step 3. Y's average month-end liabilities to X, as computed under §1.861–10T(e)(1)(iii) for 1987 are $100,000.

Step 4. Adding the $100,000 of Y's liabilities owed to X as computed under Step 3 to Y's third party liabilities ($0) would be insufficient to make Y's debt-to-asset ratio computed in Step 2 ($100,000-to-$500,000, or 1:5) equal to at least 80 percent of X's debt-to-asset ratio computed under Step 1, as adjusted to reflect a reduction in X's debt and assets by the $100,000 of excess related person indebtedness (.80 × $900,000/$1,900,000 or 1:2.6). Therefore, the entire amount of Y's liabilities to X ($100,000) constitute excess related person indebtedness under §1.861–10T(e)(1)(ii). Thus, the entire $10,000 of interest received by X from Y during 1987 constitutes interest received on excess related person indebtedness.

Step 5. The Y note held by X has a tax book value of $100,000. Solely for purposes of §1.861–10(e)(1)(v), the Y note is attributed to separate limitation categories in the same manner as the Y stock. Under paragraph (c)(3)(iii) of this section, of the $80,000 of Y stock held by X, $50,000 is attributable to foreign source general limitation income, and $30,000 is attributable to foreign source passive income. Thus, for purposes of $1.861–10T(e)(1)(v), $62,500 of the $100,000 Y note is considered to be a foreign source general limitation asset and $37,500 of the $100,000 Y note is considered to be a foreign source passive asset.

Step 6. Since $8,000 of the $10,000 in related person interest income received by Y constitutes interest received on excessive related person indebtedness, $10,000 of X's third party interest expense is allocated to X's debt investment in Y. Under §1.861–10T(e)(1)(vi), 62.5 percent of the $10,000 of X's third party interest expense ($6,250) is allocated to foreign source general limitation income and 37.5 percent of the $10,000 of X's third party interest expense ($3,750) is allocated to foreign source passive income. As a result of this direct allocation, the value of X's assets generating foreign source general limitation income shall be reduced by the principal amount of indebtedness the interest on which is directly allocated to foreign source general limitation income ($62,500), and X's assets generating foreign general limitation income shall be reduced by the principal amount of indebtedness the interest on which is directly allocated to foreign passive income ($37,500).

(5) *Totals.*

Having allocated $10,000 of its third party interest expense to its debt investment in Y, X would apportion the $90,000 balance of its interest according to the following apportionment fractions:

Asset	Domestic source	Foreign general	Foreign passive	Noncontrolled section 902
Plant and equipment	$750,000	$250,000	.....	.....
Inventory	$150,000	$50,000	.....	.....
Automobiles	$20,000	.....	.....	.....
Patents	$37,500	$12,500	.....	.....
Trademarks	$7,500	$2,500	.....	.....
Y stock	.....	$50,000	$30,000	.....
Y note	.....	.....	$100,000	.....
Z stock	.....	.....	.....	$40,000
Totals	$965,000	$365,000	$130,000	$40,000
Adjustments for directly allocable interest	.....	($62,250)	($37,750)	.....
Adjusted totals	$965,000	$302,750	$92,250	$40,000
Percentage	69	22	6	3

Example 2. Assume the same facts as in *Example* 1, except that Y has $100,000 of third party indebtedness. Further, assume for purposes of the application of the special allocation rule of §1.861–10T(e) that the taxable year is 1990 and that the applicable percentage prescribed by §1.861–10T(e)(1)(iv)(A) is 80 percent. The application of the §1.861–10(e) would be modified as follows.

Step 1. X's debt-to-asset ratio computed under §1.861–10T(e)(1)(i) remains 1 to 2 (or 0.5).

Step 2. The tax book value of Y's assets is $500,000. Y has $100,000 of indebtedness to third parties. Y's debt-to-asset ratio computed under §1.861–10T(e)(1)(ii) is $100,000 to $500,000 (1:5 or 0.2).

Step 3. Y's average month-end liabilities to X, as computed under §1.861–10T(e)(1)(iii) remain $100,000.

Step 4. X's debt-to-asset ratio is 0.5 and 80 percent of 0.5 is 0.4. Because Y's debt-to-asset ratio is 0.2, there is excess related person indebtedness, the amount of which can be computed based on the following formula:

$$\frac{\text{Aggregate third party debt of related U.S. shareholder} - X}{\text{U.S. shareholder assets} - X} \times \begin{matrix}\text{Applicable percentage}\\ \text{for year } (0.8)\end{matrix} = \frac{\text{Aggregate third party debt of related CFCs} + X}{\text{Related CFC assets}}$$

Supplying the facts as given, this equation is as follows:

$$\frac{1{,}000{,}000 - X}{2{,}000{,}000 - X} \times .8 = \frac{100{,}000 + X}{500{,}000}$$

Multiply both sides by 500,000 and (2,000,000 – X), yielding:

$$4 \times 10^{11} - 400{,}000X = 2 \times 10^{11} + 2{,}000{,}000X - 100{,}000X - X^2$$

Since there is an X^2 in this equation, a quadratic formula must be utilized to solve for X. Group the components in this equation, segregating the X and the X^2:

$$X^2 + (-2{,}300{,}000)X + (2 \times 10^{11}) = 0$$

Apply the quadratic formula:

$$X = \frac{-b \pm \sqrt{b^2 - 4(a)(c)}}{2(a)}$$

a = 1 (coefficient of X^2)
b = −2,300,000 (coefficient of X)
c = 2×10^{11} (remaining element of equation)

Therefore, X equals either 90,519 or (2.21×10^{11}). for purposes of computing excess related person indebtedness, X is the lowest positive amount derived from this equation, which is 90,519.

Steps 5 and 6 are unchanged from *Example* 1, except that the total amount of interest on excess related party indebtedness is $9,051.

(k) *Effective/applicability date.* The rules of this section apply for taxable years beginning after December 31, 1986.

[T.D. 8228, 53 FR 35495, Sept. 14, 1988, as amended by T.D. 9260, 71 FR 24526, Apr. 25, 2006, T.D. 9452, 74 FR 27875, June 11, 2009; T.D. 9456, 74 FR 38875, Aug. 4, 2009]

§ 1.861–13T Transition rules for interest expenses (temporary regulations).

(a) *In general*—(1) *Optional application.* The rules of this section may be applied at the choice of a corporate taxpayer. In the case of an affiliated group, however, the choice must be made on a consistent basis for all members. Therefore, a corporate taxpayer (or affiliated group) may allocate and apportion its interest expense entirely on the basis of the rules contained in §§ 1.861–8T through 1.861–12T and without regard to the rules of this section. The choice is made on an annual basis and, thus, is not binding with respect to subsequent tax years.

(2) *Transition relief.* This section contains transitional rules that limit the application of the rules for allocating and apportioning interest expense of corporate taxpayers contained in §§ 1.861–8T through 1.861–12T, which are applicable in allocating and apportioning the interest expense of corporate taxpayers generally for taxable years beginning after 1986. Sections 1.861–9(d) (relating to individuals, estates, and certain trusts) and 1.861–9(e) (relating to partnerships) are effective for taxable years beginning after 1986. Thus, the taxpayers to whom those sections apply do not qualify for transition relief under this section.

(3) *Indebtedness defined.* For purposes of this section, the term ''indebtedness'' means any obligation or other evidence of indebtedness that qenerates an expense that constitutes interest expense within the meaning of § 1.861–9T(a). In the case of an obligation that does not bear interest initially, but becomes interest bearing with the lapse of time or upon the occurrence of an event, such obligation shall only be considered to constitute indebtedness when it first bears interest. Obligations that are outstanding as of November 16, 1985 shall only qualify for transition relief under this section if they bear interest-bearing as of that date. For this purpose, any obligation that has original issue discount within the meaning of section 1273(a)(1) of the Code shall be considered to be interest-bearing.

(4) *Exceptions.* The term ''indebtedness'' shall not include any obligation existing between affiliated corporations, as defined in § 1.861–llT(d). Moreover, the term ''indebtedness'' shall not include any obligation the interest on which is directly allocable under §§ 1.861–10T(b) and 1.861–10T(c). Under § 1.861–9T(b)(6)(iv)(B), certain interest expense is directly allocated to the gain derived from an appropriately identified financial product. When interest expense on a liability is reduced by such gain, the principal amount of such liability shall be reduced pro rata by the relative amount of interest expense that is directly allocated.

(b) *General phase-in*—(1) *In general.* In the case of each of the first three taxable years of the taxpayer beginning after December 31, 1986, the rules of §§ 1.861–8T through 1.861–12T shall not apply to interest expenses paid or accrued by the taxpayer during the taxable year with respect to an aggregate amount of indebtedness which does not exceed the general phase-in amount, as defined in paragraph (b)(2) of this section.

(2) *General phase-in amount defined.* Subject to the limitation imposed by paragraph (b)(3) of this section, the general phase-in amount means the amount which is the applicable percentage (determined under the following table) of the aggregate amount

of indebtedness of the taxpayer outstanding on November 16, 1985:

Taxable year beginning after December 31, 1986	Percentage
First	75
Second	50
Third	25

(3) *Reductions in indebtedness.* The general phase-in amount shall not exceed the taxpayer's historic lowest month-end debt level taking into account all months after October 1985. However, for the taxable year ln which a taxpayer attains a new historic lowest month-end debt level (but not for subsequent taxable years), the general phase-in amount shall not exceed the average of month-end debt levels within that taxable year (without taking into account any increase in month-end debt levels occurring in such taxable Year after the new historic lowest month-end debt level is attained).

Example. X is a calendar year taxpayer that had $100 of indebtedness outstanding on November 16, 1985. X's month-end debt level remained $100 for all subsequent months until July 1987, when X's month-end debt level fell to $50. In computing transition relief for 1987, X's general phase-in amount cannot exceed $75 (900 divided by 12), which is the average of month-end debt levels in 1987. Assuming that X's month-end debt level for any subsequent month does not fall below $50, the limitation on its general phase-in amount for all taxable years after 1987 will be $50, its historic lowest month-end debt level after October 1985.

(c) *Nonapplication of the consolidation rule*—(1) *General rule.* In the case of each of the first five taxable years of the taxpayer beginning after December 31, 1986, the consolidation rule contained in § 1.861–11T(c) shall not apply to interest expenses paid or accrued by the taxpayer during the taxable year with respect to an aggregate amount of indebtedness which does not exceed the special phase-in amount, as defined in paragraph (c)(2) of this section.

(2) *Special phase-in amount.* The special phase-in amount is the sum of—

(i) The general phase-in amount,

(ii) The five-year phase-in amount, and

(iii) The four-year phase-in amount.

(3) *Five-year phase-in amount.* The five-year phase-in amount is the lesser of—

(i) The applicable percentage (the ''unreduced percentage'' in the following table) of the five-year debt amount, or

(ii) The applicable percentage (the ''reduced percentage'' in the following table) of the five-year debt amount reduced by paydowns (if any):

Transition year	Unreduced percentage	Reduced percentage
Year 1	8⅓	10
Year 2	16⅔	25
Year 3	25	50
Year 4	33⅓	100
Year 5	16⅔	100

(4) *Four-year phase-in amount.* The four-year phase-in amount is the lesser of—

(i) The applicable percentage (the ''unreduced percentage'' in the following table) of the four-year debt amount, or

(ii) The applicable percentage (the ''reduced percentage'' in the following table) of the four-year debt amount reduced by paydowns (if any) to the extent that such paydowns exceed the five-year debt amount:

Transition year	Unreduced percentage	Reduced percentage
Year 1	5	6¼
Year 2	10	16⅔
Year 3	15	37½
Year 4	20	100

(5) *Five-year debt amount.* The ''five-year debt amount'' means the excess (if any) of—

(i) The amount of the outstanding indebtedness of the taxpayer on May 29, 1985, over

(ii) The amount of the outstanding indebtedness of the taxpayer on December 31, 1983. The five-year debt amount shall not exceed the aggregate amount of indebtedness of the taxpayer outstanding on November 16, 1985.

(6) *Four-year debt amount.* The ''four-year debt amount'' means the excess (if any) of—

(i) The amount of the outstanding indebtedness of the taxpayer on December 31, 1983, over

(ii) The amount of the outstanding indebtedness of the taxpayer on December 31, 1982.

The four-year debt amount shall not exceed the aggregate amount of indebtedness of the taxpayer outstanding on November 16, 1985, reduced by the five-year debt amount.

(7) *Paydowns*. The term ''paydowns'' means the excess (if any) of—

(i) The aggregate amount of indebtedness of the taxpayer outstanding on November 16, 1985, over

(ii) The limitation on the general phase-in amount described in paragraph (b)(3) of this section.

Paydowns are first applied to the five-year debt amount to the extent thereof and then to the four-year debt amount for purposes of computing the five-year and the four-year phase-in amounts.

(d) *Treatment of affiliated group*. For purposes of this section, all members of the same affiliated group of corporations (as defined in §1.861–11(d)) shall be treated as one taxpayer whether or not such members filed a consolidated return. Interaffiliate debt is not taken into account in computing transition relief. Moreover, any reduction in the amount of interaffiliate debt is not taken into account in determining the amount of paydowns.

(e) *Mechanics of computation*—(1) *Step 1: Determination of the amounts within the various categories of debt*. Each separate member of an affiliated group must determine each of its following amounts:

(i) *November 16, 1985 amount*. The amount of its debt outstanding on November 16, 1985 (after the elimination of interaffiliate indebtedness),

(ii) *Unreduced five-year debt*. The amount of any net increase in the amount of its indebtedness on May 29, 1985 (after elimination of interaffiliate indebtedness) over the amount of its indebtedness on December 31, 1983 (after elimination of interaffiliate indebtedness),

(iii) *Unreduced four-year debt*. The amount of any net increase in the amount of its indebtedness on December 31, 1983 (after elimination of interaffiliate indebtedness) over the amount of its indebtedness on December 31, 1982 (after elimination of interaffiliate indebtedness), and

(iv) *Month-end debt*. The amount of its month-end debt level for all months after October 1985 (after elimination of interaffiliate indebtedness).

(2) *Step 2: Aggregation of the separate company amounts*. Each of the designated amounts for the separate companies identified in Step 1 must be aggregated in order to compute consolidated transition relief. Paragraph (e)(10)(iv) of this section (Step 10) requires the use of the taxpayer's current year average debt level for the purpose of computing the percentages of debt that are subject to the three sets of rules that are identified in Step 10. For use in that computation, the taxpayer should compute the current year average debt level by aggregating separate company month-end debt levels and then by averaging those aggregate amounts.

(3) *Step 3: Calculation of the lowest historic month-end debt level of the taxpayer*. In order to calculate the lowest historic month-end debt level of the taxpayer, determine the month-end debt level of each separate company for each month ending after October 1985 and aggregate these amounts on a month-by-month basis. On such aggregate basis, in any taxable year in which the taxpayer attains an aggregate new lowest historic month-end debt level, add together all the aggregate month-end debt levels within the taxable year (without taking into account any increase in aggregate debt level subsequent to the attainment of such lowest historic month-end debt level) and divide by the number of months in that taxable year, yielding the average of month-end debt levels for such year. Such average shall constitute the taxpayer's lowest historic month-end debt level for that taxable year in which the aggregate new lowest historic month-end debt level was attained. Unless otherwise specified, all subsequent references to any amount refer to the aggregate amount for all members of the same affiliated group of corporations.

(4) *Step 4: Computation of paydowns*. Paydowns equal the amount by which the November 16, 1985 amount exceeds the taxpayer's lowest historic month-end debt level, determined under Step 3.

(5) *Step 5: Computation of limitations on unreduced five-year debt and unreduced four-year debt.* (i) The unreduced five-year debt cannot exceed the November 16, 1985 amount.

(ii) The unreduced four-year debt cannot exceed the November 16, 1985 amount less the unreduced five-year debt.

(6) *Step 6: Computation of reduced five-year and reduced four-year debt*—(i) *Reduced five-year debt.* Compute the amount of reduced five-year debt by subtracting from the unreduced five-year debt (see Step 5) the amount of paydowns (see Step 4).

(ii) *Reduced four-year debt.* To the extent that the amount of paydowns (see step 4) exceeds the amount of unreduced five-year debt (see Step 5), compute the amount of reduced four-year debt by subtracting such excess from the unreduced four-year debt (see Step 1).

(iii) To the extent that paydowns do not offset either the unreduced five-year amount or the unreduced four-year amount, the reduced and the unreduced amounts are the same.

(7) *Step 7: Computation of the general phase-in amount.* The general phase-in amount is the lesser of—

(i) The percentage of the November 16, 1985 amount designated for the relevant transition year in the table below, or

(ii) The lowest group month-end debt level (see Step 3).

GENERAL PHASE-IN TABLE

Transition year	Percentage
Year 1	75
Year 2	50
Year 3	25

(8) *Step 8: Computation of Five-Year Phase-in Amount.* The five-year phase-in amount is the lesser of—

(i) The percentage of the unreduced five-year debt designated for the relevant transition year in the table below, or

(ii) The percentage of the reduced five-year debt designated for the relevant transition year in the table below.

FIVE-YEAR PHASE-IN TABLE

Transition year	Unreduced percentage	Reduced percentage
Year 1	8⅓	10
Year 2	16⅔	25
Year 3	25	50
Year 4	33⅓	100
Year 5	16⅔	100

(9) *Step 9: Computation of Four-year Phase-in Amount.* The four-year phase-in amount is the lesser of—

(i) The percentage of the unreduced four-year debt designated for the relevant transition year in the table below, or

(ii) The percentage of the reduced four-year debt designated for the relevant transition year in the table below.

FOUR-YEAR PHASE-IN TABLE

Transition year	Unreduced percentage	Reduced percentage
Year 1	5	6¼
Year 2	10	16⅔
Year 3	15	37½
Year 4	20	100

(10) *Step 10: Determination of group debt ratio and application of transition relief to separate company interest expense.* (i) The general phase-in amount consists of the amount computed under Step 7. Interest expense on this amount is subject to pre-1987 rules of allocation and apportionment.

(ii) The post-1986 separate company amount consists of the sum of the amounts determined under Steps 8 and 9. Interest expense on this amount is subject to post-1986 rules of allocation and apportionment as applied on a separate company basis. Thus, §1.861–11T(c) does not apply with respect to this amount of indebtedness. Because the consolidation rule does not apply, stock in affiliated corporations shall be taken into account in computing the apportionment fractions for each separate company in the same manner as under pre-1987 rules.

(iii) The post-1986 one-taxpayer amount consists of any indebtedness that does not qualify for transition relief under Steps 7, 8, and 9. Interest expense on this amount is subject to post-1986 rules as applied on a consolidated basis.

(iv) To determine the extent to which the interest expense of each separate company is subject to any of these sets of allocation and apportionment rules, each company shall prorate its own interest expense using two fractions. The general phase-in fraction is the general phase-in amount over the current year average debt level of the affiliated group (see Step 2). The post-1986 separate company fraction is the post-1986 separate company amount over the current year average debt level of the affiliated group. The balance of each separate company's interest expense is subject to post-1986 one-taxpayer rules.

(f) *Example*. XYZ form an affiliate group.

(1) *Step 1:* Determination of the amounts within the various debt categories.

	Historic 3rd party debt	Increase
Company X:		
Nov. 16, 1985	$100,000	
May 29, 1983 (5-year)	90,000	$10,000
Dec. 31, 1983 (4-year)	80,000	10,000
Dec. 31, 1982	70,000	
Current Interest Expense	10,000	
Company Y:		
Nov. 16, 1985	200,000	
May 29, 1985 (5-year)	170,000	120,000
Dec. 31, 1983 (4-year)	50,000	10,000
Dec. 31, 1982	40,000	
Current Interest Expense	30,000	
Company Z:		
Nov. 16, 1985	300,000	
May 29, 1985 (5-year)	300,000	50,000
Dec. 31, 1983 (4-year)	250,000	100,000
Dec. 31, 1982	150,000	
Current Interest Expense	30,000	

(2) *Step 2:* Aggregation of the separate company amounts.

Aggregate Nov. 16, 1985	$600,000
Aggregate 5-year debt	180,000
Aggregate 4-year debt	120,000
Current year average debt level	700,000

(3) *Step 3:* Calculation of lowest historic month-end debt level.

An analysis of historic month-end debt levels indicates that in 1986, XYZ's aggregate month-end debt level fell to $500,000, which represents the lowest sum for all years under consideration. Because this historic low occurred in a prior tax year, there is no averaging of month-end debt levels in the current taxable year.

(4) *Step 4:* Computation of paydowns.

The aggregate November 16, 1985 amount ($600,000), less the lowest historic month-end debt level ($500,000), yields a total paydown in the amount of $100,000.

(5) *Step 5:* Computation of limitations on aggregate unreduced five-year debt and aggregate unreduced four-year debt.

Aggregate Nov. 16, 1985 amount	$600,000
Aggregate unreduced 5-year debt	180,000
Aggregate unreduced 4-year debt	120,000

Because the November 16, 1985 amount exceeds the unreduced 4- and 5-year debt, the full amount of the 4- and 5-year debt qualify for transition relief. In cases where the November 16, 1985 amount is less than the 4- or 5-year debt (or the sum of both), the latter amounts are limited to the November 16, 1985 amount. See the limitations on the 4-year and 5-year debt amounts in paragraphs (c)(6) and (c)(5), respectively, of this section.

(6) *Step 6:* Computation of reduced five-year and four-year debt. The paydowns computed under Step 4 are deemed to first offset the aggregate unreduced five-year debt. Accordingly, the reduced amount of five-year debt is $80,000. Since the paydowns are less than the aggregate unreduced five-year debt, there is no paydown in connection with aggregate unreduced four-year debt. Accordingly, the unreduced four-year debt and the reduced four-year debt are both considered to be $120,000.

(7) *Step 7:* Computation of the general phase-in amount. In transition year 1, the general transition amount is the lesser of:

(i) 75 percent of the aggregate November 16, 1985 amount (75% of $600,000 = $450,000); or

(ii) the lowest month-end debt level since November 16, 1985 ($500,000).

Therefore, the general transition amount is $450,000.

(8) *Step 8:* Computation of the five-year phase-in amount. In transition year 1, the five-year phase-in amount is the lesser of:

(i) 8⅓ percent of the unreduced five-year amount (8⅓% of $180,000 = $15,000); or

(ii) 10 percent of the reduced five-year amount (10% of $80,000 = $8,000).

Therefore, the five-year phase-in amount is $8,000.

(9) *Step 9:* Computation of the four-year phase-in amount. In transition year 1, the four-year phase-in amount is the lesser of:

(i) 5 percent of the unreduced four-year amount (5% of $120,000 = $6,000); or

(ii) 6¼ percent of the reduced four-year amount (6¼% of $120,000 = $7,500).

Therefore, the four-year phase-in amount is $6,000.

(10) *Step 10:* Determination of group debt ratio and application of relief to separate company interest expense.

(i) As determined under Step 7, interest expense on a total of $450,000 of the XYZ debt in the first transition year is computed under pre-1987 rules of allocation and apportionment.

(ii) The sum of Steps 8 ($8,000) and 9 ($6,000) is $14,000. Interest expense on a total of $14,000 of XYZ debt is computed under post-1986 rules of allocation and apportionment as applied on a separate company basis.

(iii) The balance of XYZ's current year interest expense is computed under post-1986 rules of allocation and apportionment as applied on a consolidated basis. X, Y, and Z, respectively, have current interest expense of $10,000, $30,000, and $30,000. Thus, 64.3 percent (450,000/700,000) of the interest expense of each separate company is subject to pre-1987 rules. Two percent (14,000/700,000) of the interest expense of each separate company is subject to post-1986 rules applied on a separate company basis. Finally, the balance of each separate company's current year interest expense (33.7 percent) is subject to post-1986 rules applied on a consolidated basis.

(g) *Corporate transfers*—(1) *Effect on transferee*—(i) *General rule.* Except as provided in paragraph (g)(1)(ii) of this section, if a domestic corporation or an affiliated group acquires stock in a domestic corporation that was not a member of the transferee's affiliated group before the acquisition, but becomes a member of the transferee's affiliated group after the acquisition, the transferee group shall take into account the following transition attributes of the acquired corporation in computing its transition relief:

(A) November 16, 1985 amount;

(B) Unreduced five-year amount;

(C) Unreduced four-year amount; and

(D) The amount of any transferor paydowns attributed to the acquired corporation under the rules of paragraph (h)(1) of this section.

(ii) *Special rule for year of acquisition.* To compute the amount of the transition attributes described in paragraph (g)(1)(i) of this section that a transferee takes into account in the transferee's taxable year of the acquisition, such transition attributes shall be multiplied by a fraction, the numerator of which is the number of months within the taxable year that the transferee held the acquired corporation and the denominator of which is the number of months in such taxable year. In order for the transferee to assert ownership of a subsidiary for a given month, the transferee and the acquired corporation must be affiliated corporations as of the last day of the month. In addition, the transferor and the transferee shall take account of the month-end debt level of the transferred corporation only for those months at the end of which the transferred corporation was a member of the transferor's or the transferee's respective affiliated group.

(iii) *Aggregation of transition attributes.* The transition attributes of the acquired corporation shall be aggregated with the respective amounts of the transferee group.

(iv) *Conveyance of transferor paydowns.* The total paydowns of the transferee group shall include the amount of any paydown of the transferor group that was attributed to the acquired corporation under the rules of paragraph (h)(1) of this section.

(v) *Effect of certain elections.* If an election—

(A) Is made under section 338(g) (whether or not an election under 338(h)(10) is made),

(B) Is deemed to be made under section 338(e) (other than (e)(2)), or section 338(f), or,

(C) Is made under section 336(e), no indebtedness of the acquired corporation shall qualify for transition relief for the year such election first becomes effective and for subsequent taxable years, and no other transition attributes of the acquired corporation

shall be taken into account by the transferee group.

(2) *Effect on transferor*—(i) *General rule*. Except as provided in paragraph (g)(2)(ii) of this section, in the case of an acquisition of a member of an affiliated group by a nonmember of the group, the transferor shall not take into account the transition attributes of the acquired corporation in computing the transition relief of the transferor group in subsequent taxable years. Thus, the November 16, 1985 amount, the unreduced five-year and four-year debt amounts, and the end-of-month debt levels of the transferor group shall be computed without regard to the acquired corporation's respective amounts for purposes of computing transition relief of the tranferor group for years thereafter.

(ii) *Special rule for the year of disposition*. To compute the amount of the transition attributes described in paragraph (g)(2)(i) of this section that a transferor shall take into account in the transferor's taxable year of the disposition, such transition attributes shall be multiplied by a fraction, the numerator of which is the number of months within the taxable year that the transferor held the acquired corporation and the denominator of which is the number of months in such taxable year. In order for the transferor to assert ownership of a subsidiary for a given month, the transferor and the acquired corporation must be affiliated corporations as of the last day of the month.

(iii) *Effect of prior paydowns*. Any paydowns of the acquired corporation that are considered to reduce the debt of other members of the transferor group under the rules of paragraph (h)(1) of this section (whether incurred in a prior taxable year or in that portion of a year of disposition that is taken into account by the transferor) shall continue to be taken into account by the transferor group after the disposition.

(3) *Special rule for assumptions of indebtedness*. In connection with the transfer of a corporation, if the indebtedness of an acquired corporation is assumed by any party other than the transferee or another member of the transferee's affiliated group, the transition attributes of the acquired corporation shall not be taken into account in computing the transition relief of the transferee group. See paragraph (g)(2) of this section concerning the treatment of the transferor group. Also in connection with the transfer of a corporation, if the transferee or another member of the transferee's affiliated group assumes the indebtedness of an acquired corporation, such assumed indebtedness shall only qualify for transition relief during the period in which the acquired corporation remains a member of the transferee group. Further, if the transferee group subsequently disposes of the acquired corporation, the indebtedness of the acquired corporation will continue to qualify for transition relief only if the indebtedness is assumed by the new purchaser as of the time such corporation is acquired.

(4) *Effect of asset sales*. If substantially all of the assets of a corporation are sold, the indebtedness of such corporation shall cease to be qualified for transition relief. Thus, the transition attributes of such corporation shall not be taken into account in computing transition relief.

(h) *Rules for attributing paydowns among separate companies*—(1) *General rule*. In the case of a corporate transfer under paragraph (g) of this section, it is necessary to determine the amount of paydowns attributable to the acquired corporation. Under paragraph (c)(7) of this section, paydowns are deemed to reduce first the five-year phase-in amount, then the four-year phase-in amount, and then the general phase-in amount. Thus, for example, a reduction in indebtedness of the group caused by a reduction in the debt of a group member that has no five-year debt will nevertheless be deemed under this ordering rule to reduce the indebtedness of those group members that do have five-year debt. In order to preserve the effect of paydowns caused by a reduction, each member must determine on a separate company basis at the time of any transfer of any member of the affiliated group the impact of paydowns (including those paydowns occurring in the year of transfer prior to the time of the transfer) on the various categories of indebtedness.

(2) *Mechanics of computation*. Separate company accounts of paydowns are determined by prorating any paydown among all group members with five-year debt to the extent thereof on the basis of the relative amounts of five-year debt. Paydowns in excess of five-year debt are prorated on a similar basis among all group members with four-year debt to the extent thereof on the basis of the relative amounts of four-year debt. Paydowns in excess of four-year and five-year debt are prorated among all group members with general phase-in debt to the extent thereof on the basis of the relative amounts of general phase-in debt. After an initial paydown has been prorated among the members of an affiliated group, any further reduction in the amount of aggregate month-end debt level as compared to the November 16, 1985 amount is prorated among all members of the affiliated group based on the remaining net amounts of four-year and five-year debt.

(3) *Examples*. The rules of paragraphs (g) and (h) of this section may be illustrated by the following examples.

Example 1. Computing separate company accounts of reductions. (i) *Facts*. XYZ constitutes an affiliated group of corporations that has a calendar taxable year and the following transition attributes:

	Historic 3rd party debt	Increase
Company X:		
Nov. 16, 1985	$100,000	
May 29, 1985 (5-year)	80,000	$0
Dec. 31, 1983 (4-year)	80,000	10,000
Dec. 31, 1982	70,000	
Company Y:		
Nov. 16, 1985	200,000	
May 29, 1985 (5-year)	170,000	120,000
Dec. 31, 1983 (4-year)	50,000	10,000
Dec. 31, 1982	40,000	
Company Z:		
Nov. 16, 1985	300,000	
May 29, 1985 (5-year)	290,000	40,000
Dec. 31, 1983 (4-year)	250,000	100,000
Dec. 31, 1982	150,000	

In 1986, the XYZ group attained its lowest historic month-end debt level of $500,000. Because the November 16, 1985 amount is $600,000 the XYZ group therefore has a paydown in the amount of $100,000. This paydown partially offsets the $160,000 of five-year debt in the XYZ group.

(ii) *Analysis*. Applying the rule of paragraph (h)(1) of this section, separate company accounts of paydowns are computed by prorating the $100,000 paydown among those members of the group that have five-year debt. Accordingly, the paydown is prorated between Y and Z as follows:

To Y:

$$\$100,000 \times \frac{\$120,000}{\$160,000} = \$75,000$$

To Z:

$$\$100,000 \times \frac{\$40,000}{\$160,000} = \$25,000$$

Example 2. Corporate acquisitions. (i) *Facts*. The facts are the same as in example 1. On July 15, 1987, the XYZ group sells all the stock of Y to A. Having held the stock of Y for six months in 1987, the XZ group computes its transition relief for that year taking into account half of the transition attributes of Y. AY constitutes an affiliated group of corporations after the acquisition. Having held the stock of Y for six months in 1987, the AY group computes its transition relief for that year taking into account half of the transition attributes of Y. In 1987, the AY group attained a new lowest month-end debt level that yields an average lowest month-end debt level for 1987 of $150,000.

(ii) *Transferee group*. The following analysis applies in determining transition relief for purposes of apportioning the interest expense of the transferee group for 1987. The AY group has the following transition attributes for 1987:

	Historic 3rd party debt	Increase
Company A:		
Nov. 16, 1985	$100,000	
May 29, 1985 (5-year)	250,000	$5,000
Dec. 31, 1983 (4-year)	245,000	10,000
Dec. 31, 1982	235,000	
Company Y (half-year amounts):		
Nov. 16, 1985	100,000	
May 29, 1985 (5-year)	85,000	60,000
Dec. 31, 1983 (4-year)	25,000	5,000
Dec. 31, 1982	20,000	
Pre-acquisition year paydown by another member of the transferor group that reduced Y's five-year debt (one half of $75,000)	37,500	

Because the November 16, 1985 amount of the AY group in 1987 is $200,000 and because the 1987 average of historic month-end debt levels was $150,000, the AY group has a paydown in the amount of $50,000. In addition, the 1986 paydown by the XYZ group that was deemed to reduce Y debt is added to the paydown computed above, yielding a total paydown of $87,500. This amount is prorated between members, eliminating the four and five year debt of the AY group. Note that Y is only a

member of the AY group for half of the 1987 taxable year. In 1988, Y's entire transition indebtedness and a $75,000 paydown must be taken into account in computing the amount of interest expense eligible for transition relief.

(iii) *Transferor group.* The following analysis applies in determining transition relief for purposes of apportioning the interest expense of the transferor group for 1987. The XZ group has the transition attributes stated below for 1987. In 1987, the XZ group attained a new lowest month-end debt level that yields an average lowest month-end debt level for 1987 of $250,000.

	Historic 3rd party debt	Increase
Company X:		
Nov. 16, 1985	$100,000	
May 29, 1985 (5-year)	80,000	$0
Dec. 31, 1983 (4-year)	80,000	10,000
Dec. 31, 1982	70,000	
Pre-disposition paydown that reduced X's debt	0	
Company Y (half-year amounts):		
Nov. 16, 1985	100,000	
May 29, 1985 (5-year)	85,000	60,000
Dec. 31, 1983 (4-year)	25,000	5,000
Dec. 31, 1982	20,000	
Pre-disposition paydown that reduced Y's debt	37,500	
Company Z:		
Nov. 16, 1985	300,000	
May 29, 1985 (5-year)	290,000	40,000
Dec. 31, 1983 (4-year)	250,000	100,000
Dec. 31, 1982	150,000	
Pre-disposition paydown that reduced Z's debt	25,000	

Because the revised November 16, 1985 amount of the XZ group is $500,000 and because the 1987 average of lowest historic month-end debt levels of the XZ group was $250,000, the XZ group has a paydown in the amount of $250,000. This paydown offsets the total five and four year debt of the XZ group. Had the 1987 paydown of the XZ group been an amount less than the five-year amount, the paydown would have been prorated based on Y's adjusted 5-year amount of $22,500 and Z's adjusted 5-year amount of $15,000.

[T.D. 8257, 54 FR 31820, Aug. 2, 1989]

§ 1.861–14 Special rules for allocating and apportioning certain expenses (other than interest expense) of an affiliated group of corporations.

(a)–(c) [Reserved]. For further guidance, see § 1.861–14T(a) through (c).

(d) *Definition of affiliated group*—(1) *General rule.* For purposes of this section, the term *affiliated group* has the same meaning as is given that term by section 1504, except that section 936 corporations (as defined in § 1.861–11(d)(2)(ii)) are also included within the affiliated group to the extent provided in paragraph (d)(2) of this section. Section 1504(a) defines an affiliated group as one or more chains of includible corporations connected through 80-percent stock ownership with a common parent corporation which is an includible corporation (as defined in section 1504(b)). In the case of a corporation that either becomes or ceases to be a member of the group during the course of the corporation's taxable year, only the expenses incurred by the group member during the period of membership shall be allocated and apportioned as if all members of the group were a single corporation. In this regard, the apportionment factor chosen shall relate only to the period of membership. For example, if apportionment on the basis of assets is chosen, the average amount of assets (tax book value or fair market value) for the taxable year shall be multiplied by a fraction, the numerator of which is the number of months of the corporation's taxable year during which the corporation was a member of the affiliated group, and the denominator of which is the number of months within the corporation's taxable year. If apportionment on the basis of gross income is chosen, only gross income generated during the period of membership shall be taken into account. If apportionment on the basis of units sold or sales receipts is chosen, only units sold or sales receipts during the period of membership shall be taken into account. Expenses incurred by the group member during its taxable year, but not during the period of membership, shall be allocated and apportioned without regard to other members of the group. This paragraph (d)(1) applies to taxable years beginning after December 31, 1989.

(2) *Inclusion of section 936 corporations*—(i) *General rule.* Except as otherwise provided in paragraph (d)(2)(ii) of this section, the exclusion from the affiliated group of section 936 corporations under section 1504(b)(4) does not apply for purposes of this section. Thus, a section 936 corporation that meets the ownership requirements of

section 1504(a) is a member of the affiliated group.

(ii) *Exception for purposes of alternative minimum tax*. The exclusion from the affiliated group of section 936 corporations under section 1504(b)(4) shall be operative for purposes of the application of this section solely in determining the amount of foreign source alternative minimum taxable income within each separate category and the alternative minimum tax foreign tax credit pursuant to section 59(a). Thus, a section 936 corporation that meets the ownership requirements of section 1504(a) is not a member of the affiliated group for purposes of determining the amount of foreign source alternative minimum taxable income within each separate category and the alternative minimum tax foreign tax credit pursuant to section 59(a).

(iii) *Effective date*. This paragraph (d)(2) applies to taxable years beginning after December 31, 1989.

(d)(3) through (e)(5) [Reserved]. For further guidance, see §1.861–14T(d)(3) through (e)(5).

(e)(6) *Charitable contribution expenses*—(i) *In general*. A deduction for a charitable contribution by a member of an affiliated group shall be allocated and apportioned under the rules of §§1.861–8(e)(12) and 1.861–14T(c)(1).

(ii) *Effective date*. (A) The rules of this paragraph shall apply to charitable contributions subject to §1.861–8(e)(12)(i) that are made on or after July 28, 2004, and, for taxpayers applying the second sentence of §1.861–8(e)(12)(iv)(A), to charitable contributions made during the taxable year ending on or after July 28, 2004.

(B) The rules of this paragraph shall apply to charitable contributions subject to §1.861–8(e)(12)(ii) that are made on or after July 14, 2005, and, for taxpayers applying the second sentence of §1.861–8(e)(12)(iv)(B), to charitable contributions made during the taxable year ending on or after July 14, 2005.

(f) through (j) [Reserved] For further guidance, see §1.861–14T(f) through (j).

[T.D. 8916, 66 FR 274, Jan. 3, 2001, as amended by T.D. 9211, 70 FR 40663, July 14, 2005]

§1.861–14T Special rules for allocating and apportioning certain expenses (other than interest expense) of an affiliated group of corporations (temporary).

(a) *In general*. Section 1.861–11T provides special rules for allocating and apportioning interest expense of an affiliated group of corporations. The rules of this §1.861–14T also relate to affiliated groups of corporations and implement section 864(e)(6), which requires affiliated group allocation and apportionment of expenses other than interest which are not directly allocable and apportionable to any specific income producing activity or property. In general, the rules of this section apply to taxable years beginning after December 31, 1986. Paragraph (b) of this section describes the scope of the application of the rule for the allocation and apportionment of such expenses of affiliated groups of corporations. Such rule is then set forth in paragraph (c) of this section. Paragraph (d) of this section contains the definition of the term ''affiliated group'' for purposes of this section. Paragraph (e) of this section describes the expenses subject to allocation and apportionment under the rules of this section. Paragraph (f) of this section provides rules concerning the affiliated group allocation and apportionment of such expenses in computing the combined taxable income of a FSC or DISC and its related supplier. Paragraph (g) of this section describes the treatment of losses caused by apportionment of such expenses in the case of an affiliated group that does not file a consolidated return. Paragraph (h) of this section provides rules concerning the treatment of the reserve expenses of a life insurance company. Paragraph (j) of this section provides examples illustrating the application of this section.

(b) *Scope*—(1) *Application of section 864(e)(6)*. Section 864(e)(6) and this section apply to the computation of taxable income for purposes of computing separate limitations on the foreign tax credit under section 904. Section 864(e)(6) and this section also apply in connection with section 907 to determine reductions in the amount allowed as a foreign tax credit under section 901. Section 864(e)(6) and this section

also apply to the computation of the combined taxable income of the related supplier and a foreign sales corporation (FSC) (under sections 921 through 927) as well as the combined taxable income of the related supplier and a domestic international sales corporation (DISC) (under sections 991 through 997).

(2) *Nonapplication of section 864(e)(6).* Section 864(e)(6) and this section do not apply to the computation of subpart F income of controlled foreign corporations (under sections 951 through 964) or the computation of effectively connected taxable income of foreign corporations.

(3) *Application of section 864(e)(6) to the computation of combined taxable income of a possessions corporation and its affiliates.* [Reserved]

(c) *General rule for affiliated corporations*—(1) *General rule.* (i) Except as otherwise provided in paragraph (c)(2) of this section, the taxable income of each member of an affiliated group within each statutory grouping shall be determined by allocating and apportioning the expenses described in paragraph (e) of this section of each member according to apportionment fractions which are computed as if all members of such group were a single corporation. For purposes of determining these apportionment fractions, any interaffiliate transactions or property that are duplicative with respect to the measure of apportionment chosen shall be eliminated. For example, in the application of an asset method of apportionment, stock in affiliated corporations shall not be taken into account, and loans between members of an affiliated group shall be treated in accordance with the rules of §1.861–11T(e). Similarly, in the application of a gross income method of apportionment, interaffiliate dividends and interest, gross income from sales or services, and other interaffiliate gross income shall be eliminated. Likewise, in the application of a method of apportionment based on units sold or sales receipts, interaffiliate sales shall be eliminated.

(ii) Except as otherwise provided in this section, the rules of §1.861–8T apply to the allocation and apportionment of the expenses described in paragraph (e) of this section. Thus, allocation under this paragraph (c) is accomplished by determining, with respect to each expense described in paragraph (e), the class of gross income to which the expense is definitely related and then allocating the deduction to such class of gross income. For this purpose, the gross income of all members of the affiliated group must be taken in account. Then, the expense is apportioned by attributing the expense to gross income (within the class to which the expense has been allocated) which is in the statutory grouping and to gross income (within the class) which is in the residual grouping. Section 1.861–8T(c)(1) identifies a number of factors upon which apportionment may be based, such as comparison of units sold, gross sales or receipts, assets used, or gross income. The apportionment method chosen must be applied consistently by each member of the affiliated group in apportioning the expense when more than one member incurred the expense or when members incurred separate portions of the expense. The apportionment fraction must take into account the apportionment factors contributed by all members of the affiliated group. In the case of an affiliated group of corporations that files a consolidated return, consolidated foreign tax credit limitations are computed for the group in accordance with the rules of §1.1502–4. For purposes of this section the term ''taxpayer'' refers to the affiliated group (regardless of whether the group files a consolidated return), rather than to the separate members thereof.

(2) *Expenses relating to fewer than all members.* An expense relates to fewer than all members of an affiliated group if the expense is allocable under paragraph (e)(1) of this section to gross income of at least one member other than the member that incurred the expense but fewer than all members of the affiliated group. The taxable income of the member that incurred the expense shall be determined by apportioning that expense under the rules of paragraph (c)(1) of this section as if the members of the affiliated group that derive gross income to which such expense is allocable under paragraph (e)(1) were treated as a single corporation.

(3) *Prior application of section 482*. The rules of this section do not supersede the application of section 482 and the regulations thereunder. Section 482 may be applied effectively to deny a deduction for an expense to one member of an affiliated group and to allow a deduction for that expense to another member of the affiliated group. In cases to which section 482 is applied, expenses shall be reallocated and reapportioned under section 864(e)(6) and this section after taking into account the application of section 482.

(d)(1)–(2) [Reserved]. For further guidance, see § 1.861–14(d)(1) and (2).

(e) *Expenses to be allocated and apportioned under this section*—(1) *Expenses not directly traceable to specific income producing activities or property*. (i) The expenses that are required to be allocated and apportioned under the rules of this section are expenses related to certain supportive functions, research and experimental expenses, stewardship expenses, and legal and accounting expenses, to the extent that such expenses are not directly allocable to specific income producing activities or property solely of the member of the affiliated group that incurred the expense. Interest expense of members of an affiliated group of corporations is allocated and apportioned under § 1.861–11T and not under the rules of this section. Expenses that are included in inventory costs or that are capitalized are not subject to allocation and apportionment under the rules of this section.

(ii) An item of expense is not considered to be directly allocable to specific income producing activities or property solely of the member incurring the expense if, were all members of the affiliated group treated as a single corporation, the expense would not be considered definitely related, within the meaning of § 1.861–8T(b)(2), only to a class of gross income derived solely by the member which actually incurred the expense. Furthermore, the expense is presumed not to be definitely related only to a class of gross income derived solely by the member incurring the expense (and is, therefore, presumed not to be directly allocable to specific income producing activities or property of that member) unless the taxpayer is able affirmatively to establish otherwise. As provided in paragraph (c)(1) of this section, expenses described in this paragraph (e)(1) generally shall be apportioned by the member incurring the expense according to apportionment fractions computed as if all members of the affiliated group were a single corporation. Under paragraph (c)(2) of this section, however, an expense shall be apportioned according to apportionment fractions computed as if only some (but fewer than all) members of the affiliated group were a single corporation, if the expense is considered allocable to gross income of at least one member other than the member incurring the expense but fewer than all members of the affiliated group. An item of expense shall be considered to be allocable to gross income of fewer than all members of the group if, were all members of the affiliated group treated as a single corporation, the expense would not be considered definitely related within the meaning of § 1.861–8T(b)(2) to gross income derived by all members of the group. In such case, the expense shall be considered allocable, for purposes of paragraph (c)(2) of this section, to gross income of those members of the group that generated (or could reasonably be expected to generate) the gross income to which the expense would be considered definitely related if the group were treated as a single corporation.

(2) *Research and experimental expenses*—(i) *In general*. The allocation and apportionment of research and experimental expenses is governed by the rules of § 1.861–8T(e)(3). In the case of research and experimental expenses incurred by a member of an affiliated group, the rules of § 1.861–8T(e)(3) shall be applied as if all members of the affiliated group were a single taxpayer. Thus, research and experimental expenses shall be allocated to all income of all members of the affiliated group reasonably connected with the relevant broad product category to which such expenses are definitely related under § 1.861–8T(e)(3)(i). If fewer than all members of the affiliated group derive gross income reasonably connected with that relevant broad product cagetory, then such expenses shall be apportioned under the rules of this

paragraph (c)(2) only among those members, as if those members were a single corporation. See *Example* (1) of paragraph (j) of this section. Such expenses shall then be apportioned, if the sales method is used, in accordance with the rules of § 1.861–8T(e)(3)(ii) between the statutory grouping (within the class of gross income) and the residual grouping (within the class of gross income) taking into account the amount of sales of all members of the affiliated group from the product category which resulted in such gross income. Section 1.861–8T(e)(3)(ii)(D), relating to sales of controlled parties, shall be applied as if all members of the affiliated group were the ''taxpayer'' referred to therein. If either of the optional gross income methods of apportionment is used, gross income of all members of the affiliated group that generate, have generated, or could reasonably have been expected to generate gross income within the relevant class of gross income must be taken into account.

(ii) *Expenses subject to the statutory moratorium.* The rules of this section do not apply to research and experimental expenses allocated under section 126 of Pub. L. 98–368.

(3) *Expenses related to supportive functions.* Expenses which are supportive in nature (such as overhead, general and administrative, supervisory expenses, advertising, marketing, and other sales expenses) are to be allocated and apportioned in accordance with the rules of § 1.861–8T(b)(3). To the extent that such expenses are not directly allocable under paragraph (e)(1)(ii) of this section to specific income producing activities or property of the member of the affiliated group that incurred the expense, such expenses must be allocated and apportioned as if all members of the affiliated group were a single corporation in accordance with the rules of paragraph (c) of this section. Specifically, such expenses must be allocated to a class of gross income that take into account gross income that is generated, has been generated, or could reasonably have been expected to have been generated by the members of the affiliated group. If the expenses relate to the gross income of fewer than all members of the affiliated group as determined under paragraph (c)(2) of this section, then those expenses must be apportioned under the rules of paragraph (c)(2) of this section, as if those fewer members were a single corporation. See *Example* (3) of paragraph (j) of this section. Such expenses must be apportioned between statutory and residual groupings of income within the appropriate class of gross income by reference to the apportionment factors contributed by the members of the affiliated group that are treated as a single corporation.

(4) *Stewardship expenses.* Stewardship expenses are to be allocated and apportioned in accordance with the rules of § 1.861–8T(e)(4). In general, stewardship expenses are considered definitely related and allocable to dividends received or to be received from a related corporation. If members of the affiliated group, other than the member that incurred the stewardship expense, receive or may receive dividends from the related corporation, such expense must be allocated and apportioned in accordance with the rules of paragraph (c) of this section as if all such members of the affiliated group that receive or may receive dividends were a single corporation. See *Example* (4) of paragraph (j) of this section. Such expenses must be apportioned between statutory and residual groupings of income within the appropriate class of gross income by reference to the apportionment factors contributed by the members of the affiliated group treated as a single corporation.

(5) *Legal and accounting fees and expenses.* Legal and accounting fees and expenses are to be allocated and apportioned under the rules of § 1.861–8T (e)(5). To the extent that such expenses are not directly allocable under paragraph (e)(1)(ii) of this section to specific income producing activities or property of the member of the affiliated group that incurred the expense, such expenses must be allocated and apportioned as if all members of the affiliated group were a single corporation. Specifically, such expenses must be allocated to a class of gross income that takes into account the gross income which is generated, has been generated, or could reasonably have been expected to have been generated by the

other members of the affiliated group. If the expenses relate to the gross income of fewer than all members of the affiliated group as determined under paragraph (c)(2) of this section, then those expenses must be apportioned under the rules of paragraph (c)(2) of this section, as if those fewer members were a single corporation. See *Example* (5) of paragraph (j) of this section. Such expenses must be apportioned taking into account the apportionment factors contributed by the members of the group that are treated as a single corporation.

(f) *Computation of FSC or DISC combined taxable income.* In the computation under the pricing rules of sections 925 and 994 of the combined taxable income of any FSC or DISC and its related supplier which are members of an affiliated group, the combined taxable income of such FSC or DISC and its related supplier shall be reduced by the portion of the expenses of the affiliated group described in paragraph (e) of this section that is incurred in connection with export sales involving that FSC or DISC. In order to determine the portion of the expenses of the affiliated group that is incurred in connection with export sales by or through a FSC or DISC, the portion of the total of the apportionment factor chosen that relates to the generation of that export income must be determined. Thus, if gross income is the apportionment factor chosen, the portion of total gross income of the affiliated group that consists of combined gross income derived from transactions involving the FSC or DISC and related supplier must be determined. Similarly, if units sold or sales receipts is the apportionment factor chosen, the portion of total units sold or sales receipts that generated export income of the FSC or DISC and related supplier must be determined. The amount of the expense shall then be multiplied by a fraction, the numerator of which is the export related apportionment factor as determined above, and the denominator of which is the total apportionment factor. Thus, if gross income is the apportionment factor chosen, apportionment is based on a fraction, the numerator of which is export related combined gross income of the FSC or DISC and related supplier and the denominator of which is the total gross income of the affiliated group. Similarly, if units sold or sales receipts is the apportionment factor chosen, the fraction is the units sold or sales receipts that generated export income of the FSC or DISC and related supplier over the total units sold or sales receipts of the affiliated group. Under this rule, expenses of other group members may be attributed to the combined gross income of a FSC of DISC and its related supplier without affecting the amount of expenses (other than any commission payable by the related supplier to the FSC or DISC) otherwise deductible by the FSC or DISC, the related supplier, or other members of the affiliated group. The FSC or DISC must calculate combined taxable income, taking into account any reduction by expenses attributed from other members of the affiliated group to determine the commission derived by the FSC or DISC or the transfer price of qualifying export property sold to the FSC or DISC.

(g) *Losses created through apportionment.* In the case of an affiliated group that does not file a consolidated return, the taxable income in any separate limitation category must be adjusted under this paragraph (g) for purposes of computing the separate foreign tax credit limitations under section 904(d). As a consequence of the affiliated group allocation and apportionment of expenses required by section 864(e)(6) and this section, expenses of a group member may be apportioned for section 904 purposes to a limitation category with a consequent loss in that limitation category. For purposes of this paragraph, the term ''limitation category'' includes domestic source income, as well as the types of income described in section 904(d)(1) (A) through (I). A loss of one affiliate in a limitation category will reduce the income of another member in the same limitation category if a consolidated return is filed. (*See* §1.1502–4.) If a consolidated return is not filed, this netting does not occur. Accordingly, in such a case, the following adjustments among members are required, in order to give effect to the group allocation of expense:

(1) Losses created through group apportionment of expense in one or more limitation categories within a given member must be eliminated; and

(2) A corresponding amount of income of other members in the same limitation category must be recharacterized.

Such adjustments shall be accomplished in accordance with the rules of § 1.861–11T(g).

(h) *Special rule for the allocation of reserve expenses of a life insurance company*. An amount of reserve expenses of a life insurance company equal to the dividends received deduction that is disallowed because it is attributable to the policyholders' share of dividends received shall be treated as definitely related to such dividends. The remaining reserve expenses of such company shall be allocated and apportioned under the rules of § 1.861–8 and this section.

(i) [Reserved]

(j) *Examples*. The rules of this section may be illustrated by the following examples. All of these examples assume that section 482 has not been applied by the Commissioner.

Example 1: (i) *Facts*. P owns all of the stock of X and all of the stock of Y. P, X and Y are domestic corporations. P is a holding company for the stock of X and Y. Both X and Y manufacture and sell a product which is included in a broad product category listed in § 1.861–8(e)(3)(i). During 1988, X incurred $100,000 on research connected with that product. All of the research was performed in the United States. In 1988, the domestic sales by X of the product totalled $400,000 and the foreign sales of the product totalled $200,000; Y's domestic sales of the product totalled $200,000 and Y's foreign sales of the product totalled $200,000. In 1988, X's gross income is $300,000, of which $200,000 is from domestic sales and $100,000 is from foreign sales; Y's gross income is $200,000 of which $100,000 is from domestic sales and $100,000 is from foreign sales.

(ii) P, X and Y are affiliated corporations within the meaning of section 864(e)(5) and this section. The research expenses incurred by X are allocable to all income connected with the relevant broad category listed in § 1.861–8T(e)(3)(i). Both X and Y have gross income includible within the class of gross income related to that product category. Accordingly, the research and experimental expenses incurred by X are to be allocated and apportioned as if X and Y were a single corporation. The apportionment for 1988 is as follows:

Tentative Apportionment on the Basis of Sales

Research expenses to be apportioned $100,000

Exclusive apportionment to United States source gross income..... $30,000

Research expense to be apportioned on the basis of sales..... $70,000

Apportionment of research expense to foreign source general limitation income:

$$\$70{,}000 \times \frac{\$200{,}000 + \$200{,}000}{\$600{,}000 + \$400{,}000} = \$28{,}000$$

Apportionment of research expense to United States source gross income:

$$\$70{,}000 \times \frac{\$400{,}000 + \$200{,}000}{\$600{,}000 + \$400{,}000} = \$42{,}000$$

Total apportioned deduction for research $100,000

Of which—

Apportioned to foreign source gross income $28,000

Apportioned to U.S. source gross income ($30,000 + $42,000) $72,000

Tentative Apportionment on the Basis of Gross Income

Research expense apportioned to foreign source gross income:

$$\$100,000 \times \frac{\$100,000 + \$100,000}{\$300,000 + \$200,000} = \$40,000$$

Research expense apportioned to United States income:

$$\$100,000 \times \frac{\$200,000 + \$100,000}{\$300,000 + \$200,000} = \$60,000$$

Example 2: (i) *Facts.* P owns all of the stock of X, which owns all of the stock of Y. P, X and Y are all domestic corporations. P has incurred general training program expenses of $100,000 in 1987. Employees of P, X and Y participate in the training program. In 1987, P had United States source gross income of $200,000 and foreign source general limitation income of $200,000; X had U.S. source gross income of $100,000 and foreign source general limitation income of $100,000; and Y had U.S. source gross income of $300,000 and foreign source general limitation income of $100,000.

(ii) *Analysis.* P, X and Y are an affiliated group of corporations within the meaning of section 864(e)(5). The training expenses incurred by P are not definitely related solely to specific income producing activities or property of P. The employees of X and Y also participate in the training program. Thus, this expense relates to gross income generated by P, X and Y. This expense is definitely related and allocable to all of the gross income from foreign and domestic sources of P, X and Y. It is assumed that apportionment on the basis of gross income is reasonable. The apportionment of the expense is as follows:

Apportionment of $100,000 expense to foreign source general limitation income:

$$\$100,000 \times \frac{\$200,000 + \$100,000 + \$100,000}{\$400,000 + \$200,000 + \$400,000} = \$40,000$$

Apportionment of $100,000 expense to United States source gross income:

$$\$100,000 \times \frac{\$200,000 + \$100,000 + \$300,000}{\$400,000 + \$200,000 + \$400,000} = \$60,000$$

Total apportioned expense $100,000

Example 3: (i) *Facts.* The facts are the same as in *Example* (2) above, except that only employees of P and X participate in the training program.

(ii) *Analysis.* Because only the employees of P and X participate in the training program and they perform no services for Y, the expense relates only to gross income generated by P and X. Accordingly, the $100,000 expense must be allocated and apportioned as if P and X were a single corporation. The apportionment of the $100,000 expense is as follows:

Apportionment of $100,000 expense to foreign source general limitation income:

$$\$100,000 \times \frac{\$200,000 + \$100,000}{\$400,000 + \$200,000} = \$50,000$$

Apportionment of $100,000 expense to U.S. source gross income:

$$\$100,000 \times \frac{\$200,000 + \$100,000}{\$400,000 + \$200,000} = \$50,000$$

Example 4: (i) *Facts.* P owns all of the stock of X which owns all of the stock of Y. P and X are domestic corporations; Y is a foreign corporation. In 1987 P incurred $10,000 of stewardship expenses relating to an audit of Y.

(ii) *Analysis.* The stewardship expenses incurred by P are not directly allocable to specific income producing activities or property of P. The expense is definitely related and allocable to dividends received or to be received by X. Accordingly, the expense of P is allocated and apportioned as if P and X were a single corporation. The expense is definitely related to dividends received or to be received by X from Y, a foreign corporation. Such dividends are foreign source general limitation income. Thus, the entire amount of the expense must be allocated to foreign source dividend income.

Example 5: (i) *Facts.* P owns all of the stock of X which owns all of the stock of Y. P, X and Y are all domestic corporations. In 1987, P incurred $10,000 legal expense relating to the testimony of certain employees of P in connection with litigation to which Y is a party. This expense is not allocable to specific income of Y. In 1987, Y had $100,000 foreign source general limitation income and $300,000 U.S. source gross income.

(ii) *Analysis.* The legal expenses incurred by P are not definitely related solely to specific income producing activities or property of P. The expense is definitely related and allocable to the class of gross income which includes only gross income generated by Y. Accordingly, the expense of P is allocated and apportioned as if Y were the only member of the affiliated group, as follows:

Apportionment of legal expenses to foreign source general limitation income:

$$\$10,000 \times \frac{\$100,000}{\$400,000} \ldots\ldots \$2,500$$

Apportionment of legal expenses to U.S. source gross income:

$$\$10,000 \times \frac{\$300,000}{\$400,000} \ldots\ldots \$7,500$$

Example 6: (i) *Facts.* P owns all of the stock of R, which owns all of the stock of F. P and R are domestic corporations, and F is a foreign sales corporation under section 922 of the Code. R and F have entered into an agreement whereby F is paid a commission with respect to sales of product A. In 1987, P had gross receipts of $1,000,000 from domestic sales of product A, and gross receipts of $1,000,000 from foreign sales of product A. R had gross receipts of $1,000,000 from domestic sales of product A, and $1,000,000 from export sales of product A. R's cost of goods sold attributable to export sales is $500,000. R has deductible expenses of $100,000 directly related to its export sales, and F has such deductible expenses of $100,000. During 1987, P incurred an expense of $100,000 for marketing studies involving the worldwide market for product A.

(ii) *Analysis.* P and R are an affiliated group of corporations within the meaning of section 864(e)(5) and this section. The expense incurred by P for marketing studies regarding the worldwide market for product A is an expense that is not directly related solely to the activities of P, but also to the activities of R. This expense must be allocated and apportioned under the rules of paragraph (c)(1) of this section, as if P and R were a single corporation. The expense is allocable to the class of gross income that includes all gross income generated by sales of product A. Apportionment on the basis of gross receipts is reasonable under these facts. F, a foreign corporation, is not a member of the affiliated group. However, for purposes of determining F's commission on its sales, the combined gross income of F and R must be reduced by the portion of the marketing studies expense of P that is incurred in connection with export sales involving F under the rules of paragraph (f) of this section. The computation of the combined taxable income of R and F is as follows:

Combined Taxable Income of R and F

R's gross receipts from export sales	$1,000,000
R's cost of goods sold	$500,000
Combined Gross Income	$500,000
Less:	
R's other deductible expenses	$100,000
F's other deductible expenses	100,000
Apportionment of P's expense:	

$$\$100{,}000 \times \frac{\$1{,}000{,}000}{\$200{,}000 + \$2{,}000{,}000} \ldots\ldots \$25{,}000$$

Total	$225,000
Combined Taxable Income	$275,000

(k) *Effective/applicability date.* The rules of this section apply for taxable years beginning after December 31, 1986.

[T.D. 8228, 53 FR 35501, Sept. 14, 1988, as amended by T.D. 8916, 65 FR 274, Jan. 3, 2001; T.D. 9143, 69 FR 44932, July 28, 2004; T.D. 9211, 70 FR 40663, July 14, 2005; T.D. 9456, 74 FR 38875, Aug. 4, 2009]

§ 1.861–15 Income from certain aircraft or vessels first leased on or before December 28, 1980.

(a) *General rule.* A taxpayer who owns an aircraft or vessel described in paragraph (b) of this section and who leases the aircraft or vessel to a United States person (other than a member of the same controlled group of corporations (as defined in section 1563) as the taxpayer) may elect under paragraph (f) of this section to treat all amounts includible in gross income with respect to the aircraft or vessel as income from sources within the United States for any taxable year ending after the commencement of the lease. This paragraph (a) applies only with respect to taxable years ending after August 15, 1971, and only with respect to leases entered into after that date of aircraft or vessels first leased by the taxpayer on or before December 28, 1980. An election once made applies to the taxable year for which made and to all subsequent taxable years unless it is revoked or terminated in accordance with paragraph (g) of this section. A taxpayer need not be a United States person to be eligible to make the election under this section, unless otherwise required by a provision of law not contained in the Internal Revenue Code of 1954. In addition, the taxpayer need not be a bank or other financial institution to be eligible to make this election. The term ''United States person'' as used in this section has the meaning assigned to it by section 7701(a)(30).

(b) *Property to which the election applies*—(1) *Section 38 property.* An election made under this section may be made only if the aircraft or vessel is section 38 property, or property which would be section 38 property but for section 48(a)(5) (relating to property used by governmental units), at the time the election is made and for all taxable years to which the election applies. The aircraft or vessel must be property which qualifies for the investment credit under section 38 unless the property does not qualify because it is described in section 48(a)(5). If an aircraft is used predominantly outside the United States (determined under § 1.48–1(g)(1)), it must qualify under the provisions of section 48(a)(2)(B)(i) and § 1.48–1(g)(2)(i). If a vessel is used predominantly outside the United States, it must qualify under the provisions of section 48(a)(2)(B)(iii) and § 1.48–1(g)(2)(iii). The aircraft or vessel may not be suspension or termination period property described in section 48(h) or section 49(a) (as in effect before the enactment of the Revenue Act of 1978). See paragraph (g) (3) and (4) of this section for rules which apply if the property ceases to be section 38 property.

(2) *United States manufacture or construction.* An election under this section may be made only if the aircraft or vessel is manufactured or constructed in the United States. The aircraft or vessel will be considered to be manufactured or constructed in the United States if 50 percent or more of the basis of the aircraft or vessel is attributable to value added within the United States.

(3) *Exclusion of certain property used outside the United States.* The term ''aircraft or vessel'' as used in this paragraph (b) does not include any property which is used predominantly outside the United States and which qualifies as section 38 property under—

(i) Section 48(a)(2)(B)(v), relating to containers used in the transportation of property to and from the United States,

(ii) Section 48(a)(2)(B)(vi), relating to certain property used for the purpose of exploring for, developing, removing, or transporting resources from the Outer Continental Shelf, or

(iii) Section 48(a)(2)(B)(x), relating to certain property used in international or territorial waters.

(c) *Leases or subleases to which the election applies.* At the time the election under this section is made and for all taxable years for which the election applies, the lessee of the aircraft or vessel must be a United States person. In addition, the aircraft or vessel may not be subleased to a person who is not a United States person unless the sublease is a short-term sublease. For purposes of this section, a short-term sublease is a sublease for a period of time (including any period for which the sublease may be renewed or extended) which is less than 30 percent of the asset guideline period of the aircraft or vessel leased (determined under section 167(m)). See paragraphs (g) (3) and (4) of this section for rules which apply if the requirements of this paragraph (c) are not met.

(d) *Income to which the election applies.* An election under this section applies to all amounts derived by the taxpayer with respect to the aircraft or vessel which is subject to the election. The election applies to all amounts which are includible in the taxpayer's gross income whether or not includible during or after the period of a lease to which the election applies. Amounts derived by the taxpayer with respect to the aircraft or vessel include any gain from the sale, exchange, or other disposition of the aircraft or vessel. If by reason of the allowance of expenses and other deductions, there is a loss with respect to an aircraft or vessel, the election applies to treat the loss as having a source within the United States. Similarly, if the sale, exchange or other disposition of the aircraft or vessel which is subject to an election results in a loss, it is treated as having a source within the United States. See paragraph (e)(2) of this section for the application of an election under this section to the income of certain transferees or distributees.

(e) *Effect of election*—(1) *In general.* An election under this section applies to the taxable year for which it is made and to all subsequent taxable years for which amounts in respect of the aircraft or vessel to which the election relates are includible in gross income. However, the election may be revoked under paragraph (g) (1) or (2) of this section or terminated under paragraph (g)(3) of this section.

(2) *Certain transfers involving carryover of basis.* (i) If an electing taxpayer transfers or distributes an aircraft or vessel which is subject to the election under this section, the transferee or distributee will be treated as having made an election under this section with respect to the aircraft or vessel if the basis of the aircraft or vessel in the hands of the transferee or distributee is determined by reference to its basis in the hands of the transferor or distributor. This paragraph (e)(2)(i) applies even though the transferor or distributor recognizes an amount of gain which increases basis in the hands of the transferee or distributee and even though the transferee of distributee is a nonresident alien individual or foreign corporation. For example, if a corporation distributes a vessel which is subject to an election under this section to its parent corporation in a complete liquidation described in section 332(b), the parent corporation will be required to treat all amounts includible in its gross income with respect to the vessel as income from source within the United States if, unless the election is revoked or terminated under paragraph (g) of this section, the basis of the property in the hands of the parent is determined under section 334(b)(1) (relating to the general rule on carryover of basis). In further illustration, if a corporation distributes a vessel (subject to an election) in a distribution to which section 301(a) applies, the distributee will be treated as having made the election with respect to the vessel if its basis is determined under section 301(d)(2) (relating to basis of corporate distributees) even though the basis is the fair market value of the vessel under section 301(d)(2)(A).

(ii) If a member of an affiliated group which files a consolidated return transfers an aircraft or vessel subject to an election to another member of that group, the transferee will be treated as having made the election with respect to the aircraft or vessel. In addition, if a partnership distributes an aircraft or

vessel subject to an election to a partner, the partner will be treated as having made the election with respect to the aircraft or vessel.

(iii) If paragraph (e)(2) (i) and (ii) of this section do not apply, the election under this section with respect to an aircraft or vessel will not be considered as made by a transferee or distributee.

(f) *Election*—(1) *Time for making the election*. The election under this section must be made before the expiration of the period prescribed by section 6511(a) (or section 6511(c) if the period is extended by agreement) for making a claim for credit or refund of the tax imposed by chapter 1 for the first taxable year for which the election is to apply. The period for that first taxable year is determined without regard to the special periods prescribed by section 6511(d).

(2) *Manner of making the election*. An election under this section must be made by filing with the income tax return (or an amended return) for the first taxable year for which the election is to apply a statement, signed by the taxpayer, to the effect that the election under section 861(e) is being made. The statement must—

(i) Set forth sufficient facts to identify the aircraft or vessel which is the subject of the election,

(ii) State that the aircraft or vessel was manufactured or constructed in the United States,

(iii) State that the aircraft or vessel is section 38 property described in § 1.861–9(b) which was leased to a United States person (as defined in section 7701(a)(30) of the Code) pursuant to a lease entered into after August 15, 1971,

(iv) State that the electing taxpayer is the owner of the aircraft or vessel,

(v) State the lessee of the aircraft or vessel is not a member of a controlled group of corporations (as defined in section 1563) of which the taxpayer is a member,

(vi) Give the name and taxpayer identification number of the lessee of the aircraft or vessel, and

(vii) State that the aircraft or vessel is not subject to a sublease (other than a short-term sublease) to any person who is not a United States person.

(3) *Election by partnership*. Any election under this section with respect to an aircraft or vessel owned by a partnership shall be made by the partnership. Any partnership election is applicable to each partner's partnership interest in the aircraft or vessel. However, an election made by a partner before August 8, 1979 will be recognized where the partnership made no election and the election can no longer be revoked without the consent of the Commissioner under paragraph (g)(1) of this section.

(g) *Termination of election*—(1) *Revocation without consent*. A taxpayer may revoke an election within the time prescribed in paragraph (f)(1) of this section without the consent of the Commissioner. In such a case, the taxpayer must file an amended income tax return for any taxable year to which the election applied.

(2) *Revocation with consent*. Except as provided in paragraph (g) (1) or (3) of this section, an election made under this section is binding unless consent to revoke is obtained from the Commissioner. A request to revoke the election must be made in writing and addressed to the Assistant Commissioner of Internal Revenue (Technical), Attention: T:C:C:3, Washington, DC 20224. The request must include the name and address of the taxpayer and be signed by the taxpayer or his duly authorized representative. It must specify the taxable year or years for which the revocation is to be effective and must be filed at least 90 days prior to the time (not including extensions) prescribed by law for filing the income tax return for the first taxable year for which the revocation of the election is to be effective or by November 6, 1979 whichever is later. The request must specify the grounds which are considered to justify the revocation. The Commissioner may require such additional information as may be necessary in order to determine whether the proposed revocation will be permitted. Consent will generally not be given to revoke an election where the revocation would result in treating gross income with respect to the aircraft or vessel (including any gain from the sale, exchange, or other disposition of such aircraft or vessel) as income from sources without the United States where, during the period the election

was in effect, there were losses from sources within the United States. A copy of the consent of the Commissioner to revoke must be attached to the taxpayer's income tax return (or amended return) for each taxable year affected by the revocation.

(3) *Automatic termination.* If an aircraft or vessel subject to an election under section 861(e) ceases to be section 38 property, ceases to be leased by its owner directly to a United States person, or is subleased (other than a short-term sublease) to a person who is not a United States person, within the period set forth in section 6511(a) (or section 6511(c) if the period is extended by agreement) for making a claim for credit or refund of the tax imposed by chapter 1 for the first taxable year for which the election applied, then the election with respect to such aircraft or vessel will automatically terminate. If the election terminates, the taxpayer who made the election must file an amended tax return or claim for credit or refund, as the case may be, for any taxable year to which the election applied.

(4) *Factors not causing revocation or termination.* The fact that an aircraft or vessel ceases to be section 38 property, ceases to be leased by its owner directly to a United States person, or is leased or subleased for any period of time to a person who is not a United States person, after expiration of the period set forth in section 6511(a) (or section 6511(c) if the period is extended by agreement) for making a claim for credit or refund of the tax imposed by chapter 1 for the first taxable year for which the election applied, will not cause a termination of the election made under this section with respect to the aircraft or vessel. For example, the electing taxpayer is not relieved from any of the consequences of making the election merely because the aircraft or vessel is subleased to a person who is not a United States person for a period in excess of that allowed for short-term subleases under paragraph (c) of this section after expiration of the later of 3 years from the time the return was filed for the first taxable year to which the election applied or 2 years from the time the tax was paid for that year where the period set forth in section 6511(a) has not been extended by agreement.

(5) *Effect of revocation or termination.* If an election is revoked or terminated under this paragraph (g), the taxpayer is required to recompute the tax for the appropriate taxable years without reference to section 861(e)(1).

(6) *Revocation or termination after December 28, 1980.* The rules in paragraph (g)(1) through (g)(5) continue to apply with respect to any election made pursuant to this section even though the revocation or termination may occur after December 28, 1980.

[T.D. 7635, 44 FR 46457, Aug. 8, 1979, as amended by T.D. 7928, 48 FR 55846, Dec. 16, 1983. Redesignated at 53 FR 35477, Sept. 14, 1988]

§ 1.861–16 Income from certain craft first leased after December 28, 1980.

(a) *General rule.* If a taxpayer—

(1) Owns a qualified craft (as defined in paragraph (b) of this section).

(2) Leases such qualified craft after December 28, 1980, to a United States person that is not a member of the same controlled group of corporations as the taxpayer, and

(3) The lease is the taxpayer's first lease of the craft and the taxpayer is not considered to have made an election with respect to the craft under § 1.861–9(e)(2),

then the taxpayer shall treat all amounts includible in gross income with respect to the qualified craft as income from sources within the United States for each taxable year ending after commencement of the lease. If this section applies to income with respect to a craft, it applies to all such amounts that are includible in the taxpayer's gross income, whether or not includible during or after the period of a lease to a United States person. Amounts derived by the taxpayer with respect to the qualified craft include any gain from the sale, exchange, or other disposition of the qualified craft. If this section applies to income with respect to a craft and there is a loss with respect to that craft (either due to the allowance of expenses and other deductions or due to a sale, exchange, or other disposition of the qualified craft), such loss is treated as allocable or apportionable to sources within the United States. The fact that a craft

ceases to be section 38 property, ceases to be leased by the taxpayer to a United States person, or is leased or subleased for any period of time to a person who is not a United States person will not terminate the application of this section.

(b) *Qualified craft*—(1) *In general.* A qualified craft is a vessel, aircraft, or spacecraft that—

(i) Is section 38 property (or would be section 38 property but for section 48(a)(5), relating to use by governmental units), and

(ii) Is manufactured or constructed in the United States.

(2) *Vessel.* The term ''vessel'' includes every type of watercraft capable of being used as a means of transportation on water, and any items of property that are affixed in a permanent fashion or are integral to the vessel. A vessel that is used predominately outside the United States must be described in section 48(a)(2)(B)(iii) and §1.48–1(g)(2)(iii), relating to vessels documented for use in the foreign or domestic commerce of the United States, to be a qualified craft.

(3) *Aircraft.* An aircraft used predominantly outside the United States must be described in section 48(a)(2)(B)(i) and §1.48–1(g)(2)(i), relating to aircraft registered by the Administrator of the Federal Aviation Agency, and operated to and from the United States or operated under contract with the United States, to be a qualified craft.

(4) *Spacecraft.* A spacecraft must be described in section 48(a)(2)(B)(viii) and §1.48–1(g)(2)(viii), relating to communications satellites, or any interest therein, of a United States person, to be a qualified craft.

(5) *United States manufacture or construction.* A craft will be considered to be manufactured or constructed in the United States if 50 percent or more of the basis of the craft on the date of the lease to a United States person is attributable to value added within the United States.

(c) *United States person.* For purposes of this section, the term ''United States person'' includes those persons described in section 7701(a)(30) and individuals with respect to whom an election under section 6013 (g) or (h) (relating to nonresident alien individuals married to United States citizens or residents) is in effect.

(d) *Controlled group.* For purposes of paragraph (a)(2) of this section, whether a taxpayer and a United States person are members of the same controlled group of corporations is determined under section 1563. Solely for purposes of this section, if at least 80% of the capital interest, or the profits interest, in a partnership is owned, directly or indirectly, by a member or members of a controlled group of corporations, then the partnership shall be considered a member of that controlled group of corporations. In addition, if at least 80% of the capital interest, or the profits interest, in a partnership is owned, directly or indirectly, by a corporation, then the partnership and that corporation shall be considered members of a controlled group of corporations.

(e) *Certain transfers and distributions*—(1) *Transfers and distributions involving carryover of basis.* If—

(i) The income with respect to a craft is subject to this section,

(ii) The taxpayer transfers or distributes such craft, and

(iii) The basis of such craft in the hands of the transferee or distributee is determined by reference to its basis in the hands of the transferor or distributor,

then this section will apply to the income with respect to the craft includible in the gross income of the transferee or distributee. This paragraph (e)(1) applies even though the transferor or distributor recognizes an amount of gain that increases basis in the hands of the transferee or distributee and even though the transferee or distributee is a nonresident alien or foreign corporation. For example, if a corporation distributes a craft the income of which is subject to this section to its parent corporation in a complete liquidation described in section 332(b), the parent corporation will be treated as if it satisified the requirements of paragraph (a) of this section with respect to such craft if the basis of the property in the hands of the parent corporation is determined under section 334(b) (relating to the general

rule on carryover of basis in liquidations). In further illustration, if a corporation distributes a craft the income of which is subject to this section, in a distribution to which section 301(a) applies, the distributee will be treated as if it satisfied the requirements of paragraph (a) of this section with respect to such craft if its basis is determined under section 301(d)(2) (relating to basis of corporate distributees) even though the basis may be the fair market value of the craft under section 301(d)(2)(A).

(2) *Partnerships*. If a partnership satisfies the requirements of paragraph (a)(1), (2), and (3) of this section, each partner shall treat all amounts includible in gross income with respect to the craft as income from sources within the United States for any taxable year of the partnership ending after commencement of the lease. In addition, if a partnership distributes a craft the income of which is subject to this section, to a partner, the partner will be treated as if he or she satisfied the requirements of paragraph (a) of this section with respect to such craft.

(3) *Affiliated groups*. If a member of a group of corporations that files a consolidated return transfers a craft, the income of which is subject to this section, to another member of that same group, the transferee will be treated as if it satisfied the requirements of paragraph (a) of this section with respect to the craft.

[T.D. 7928, 48 FR 55846, Dec. 16, 1983. Redesignated by T.D. 8228, 53 FR 35477, Sept. 14, 1988]

§ 1.861–17 Allocation and apportionment of research and experimental expenditures.

(a) *Allocation*—(1) *In general*. The methods of allocation and apportionment of research and experimental expenditures set forth in this section recognize that research and experimentation is an inherently speculative activity, that findings may contribute unexpected benefits, and that the gross income derived from successful research and experimentation must bear the cost of unsuccessful research and experimentation. Expenditures for research and experimentation that a taxpayer deducts under section 174 ordinarily shall be considered deductions that are definitely related to all income reasonably connected with the relevant broad product category (or categories) of the taxpayer and therefore allocable to all items of gross income as a class (including income from sales, royalties, and dividends) related to such product category (or categories). For purposes of this allocation, the product category (or categories) that a taxpayer may be considered to have shall be determined in accordance with the provisions of paragraph (a)(2) of this section.

(2) *Product categories*—(i) *Allocation based on product categories*. Ordinarily, a taxpayer's research and experimental expenditures may be divided between the relevant product categories. Where research and experimentation is conducted with respect to more than one product category, the taxpayer may aggregate the categories for purposes of allocation and apportionment; however, the taxpayer may not subdivide the categories. Where research and experimentation is not clearly identified with any product category (or categories), it will be considered conducted with respect to all the taxpayer's product categories.

(ii) *Use of three digit standard industrial classification codes*. A taxpayer shall determine the relevant product categories by reference to the three digit classification of the Standard Industrial Classification Manual (SIC code). A copy may be purchased from the Superintendent of Documents, United States Government Printing Office, Washington, DC 20402. The individual products included within each category are enumerated in Executive Office of the President, Office of Management and Budget, Standard Industrial Classification Manual, 1987 (or later edition, as available).

(iii) *Consistency*. Once a taxpayer selects a product category for the first taxable year for which this section is effective with respect to the taxpayer, it must continue to use that product category in following years, unless the taxpayer establishes to the satisfaction of the Commissioner that, due to changes in the relevant facts, a change in the product category is appropriate. For this purpose, a change in the taxpayer's selection of a product category

shall include a change from a three digit SIC code category to a two digit SIC code category, a change from a two digit SIC code category to a three digit SIC code category, or any other aggregation, disaggregation or change of a previously selected SIC code category.

(iv) *Wholesale trade category*. The two digit SIC code category ''Wholesale trade'' is not applicable with respect to sales by the taxpayer of goods and services from any other of the taxpayer's product categories and is not applicable with respect to a domestic international sales corporation (DISC) or foreign sales corporation (FSC) for which the taxpayer is a related supplier of goods and services from any of the taxpayer's product categories.

(v) *Retail trade category*. The two digit SIC code category ''Retail trade'' is not applicable with respect to sales by the taxpayer of goods and services from any other of the taxpayer's product categories, except wholesale trade, and is not applicable with respect to a DISC or FSC for which the taxpayer is a related supplier of goods and services from any other of the taxpayer's product categories, except wholesale trade.

(3) *Affiliated Groups*—(i) *In general*. Except as provided in paragraph (a)(3)(ii) of this section, the allocation and apportionment required by this section shall be determined as if all members of the affiliated group (as defined in § 1.861–14T(d)) were a single corporation. See § 1.861–14T.

(ii) *Possessions corporations*. (A) For purposes of the allocation and apportionment required by this section, sales and gross income from products produced in whole or in part in a possession by an electing corporation (within the meaning of section 936(h)(5)(E)), and dividends from an electing corporation, shall not be taken into account, except that this paragraph (a)(3)(ii) shall not apply to sales of (and gross income and dividends attributable to sales of) products with respect to which an election under section 936(h)(5)(F) is not in effect.

(B) The research and experimental expenditures taken into account for purposes of this section shall be reduced by the amount of such expenditures included in computing the cost-sharing amount (determined under section 936(h)(5)(C)(i)).

(4) *Legally mandated research and experimentation*. Where research and experimentation is undertaken solely to meet legal requirements imposed by a political entity with respect to improvement or marketing of specific products or processes, and the results cannot reasonably be expected to generate amounts of gross income (beyond de minimis amounts) outside a single geographic source, the deduction for such research and experimentation shall be considered definitely related and therefore allocable only to the grouping (or groupings) of gross income within that geographic source as a class (and apportioned, if necessary, between such groupings as set forth in paragraphs (c) and (d) of this section). For example, where a taxpayer performs tests on a product in response to a requirement imposed by the U.S. Food and Drug Administration, and the test results cannot reasonably be expected to generate amounts of gross income (beyond de minimis amounts) outside the United States, the costs of testing shall be allocated solely to gross income from sources within the United States.

(b) *Exclusive apportionment*—(1) *In general*. An exclusive apportionment shall be made under this paragraph (b), where an apportionment based upon geographic sources of income of a deduction for research and experimentation is necessary (after applying the exception in paragraph (a)(4) of this section).

(i) *Exclusive apportionment under the sales method*. If the taxpayer apportions on the sales method under paragraph (c) of this section, an amount equal to fifty percent of such deduction for research and experimentation shall be apportioned exclusively to the statutory grouping of gross income or the residual grouping of gross income, as the case may be, arising from the geographic source where the research and experimental activities which account for more than fifty percent of the amount of such deduction were performed.

(ii) *Exclusive apportionment under the optional gross income methods*. If the taxpayer apportions on the optional gross income methods under paragraph (d) of

this section, an amount equal to twenty-five percent of such deduction for research and experimentation shall be apportioned exclusively to the statutory grouping or the residual grouping of gross income, as the case may be, arising from the geographic source where the research and experimental activities which account for more than fifty percent of the amount of such deduction were performed.

(iii) *Exception*. If the applicable fifty percent geographic source test of the preceding paragraph (b)(1)(i) or (ii) is not met, then no part of the deduction shall be apportioned under this paragraph (b)(1).

(2) *Facts and circumstances supporting an increased exclusive apportionment*—(i) *In general*. The exclusive apportionment provided for in paragraph (b)(1) of this section reflects the view that research and experimentation is often most valuable in the country where it is performed, for two reasons. First, research and experimentation often benefits a broad product category, consisting of many individual products, all of which may be sold in the nearest market but only some of which may be sold in foreign markets. Second, research and experimentation often is utilized in the nearest market before it is used in other markets, and in such cases, has a lower value per unit of sales when used in foreign markets. The taxpayer may establish to the satisfaction of the Commissioner that, in its case, one or both of the conditions mentioned in the preceding sentences warrant a significantly greater exclusive allocation percentage than allowed by paragraph (b)(1) of this section because the research and experimentation is reasonably expected to have very limited or long delayed application outside the geographic source where it was performed. Past experience with research and experimentation may be considered in determining reasonable expectations.

(ii) *Not all products sold in foreign markets*. For purposes of establishing that only some products within the product category (or categories) are sold in foreign markets, the taxpayer shall compare the commercial production of individual products in domestic and foreign markets made by itself, by uncontrolled parties (as defined under paragraph (c)(2)(i) of this section) of products involving intangible property which was licensed or sold by the taxpayer, and by those controlled corporations (as defined under paragraph (c)(3)(ii) of this section) that can reasonably be expected to benefit directly or indirectly from any of the taxpayer's research expense connected with the product category (or categories). The individual products compared for this purpose shall be limited, for nonmanufactured categories, solely to those enumerated in Executive Office of the President, Office of Management and Budget Standard Industrial Classification Manual, 1987 (or later edition, as available), and, for manufactured categories, solely to those enumerated at a 7-digit level in the U.S. Bureau of the Census, Census of Manufacturers: 1992, Numerical List of Manufactured Products, 1993, (or later edition, as available). Copies of both of these documents may be purchased from the Superintendent of Documents, United States Government Printing Office, Washington, DC 20402.

(iii) *Delayed application of research findings abroad*. For purposes of establishing the delayed application of research findings abroad, the taxpayer shall compare the commercial introduction of its own particular products and processes (not limited by those listed in the Standard Industrial Classification Manual or the Numerical List of Manufactured Products) in the United States and foreign markets, made by itself, by uncontrolled parties (as defined under paragraph (c)(2)(i) of this section) of products involving intangible property that was licensed or sold by the taxpayer, and by those controlled corporations (as defined under paragraph (c)(3)(i) of this section) that can reasonably be expected to benefit, directly or indirectly, from the taxpayer's research expense. For purposes of evaluating the delay in the application of research findings in foreign markets, the taxpayer shall use a safe haven discount rate of 10 percent per year of delay unless he is able to establish to the satisfaction of the Commissioner, by reference to the cost of money and the number of years during which economic benefit can be directly

attributable to the results of the taxpayer's research, that another discount rate is more appropriate.

(c) *Sales method*—(1) *In general.* The amount equal to the remaining portion of such deduction for research and experimentation, not apportioned under paragraph (a)(4) or (b)(1)(i) of this section, shall be apportioned between the statutory grouping (or among the statutory groupings) within the class of gross income and the residual grouping within such class in the same proportions that the amount of sales from the product category (or categories) that resulted in such gross income within the statutory grouping (or statutory groupings) and in the residual grouping bear, respectively, to the total amount of sales from the product category (or categories).

(i) *Apportionment in excess of gross income.* Amounts apportioned under this section may exceed the amount of gross income related to the product category within the statutory grouping. In such case, the excess shall be applied against other gross income within the statutory grouping. See § 1.861–8(d)(1) for instances where the apportionment leads to an excess of deductions over gross income within the statutory grouping.

(ii) *Leased property.* For purposes of this paragraph (c), amounts received from the lease of equipment during a taxable year shall be regarded as sales receipts for such taxable year.

(2) *Sales of uncontrolled parties.* For purposes of the apportionment under paragraph (c)(1) of this section, the sales from the product category (or categories) by each party uncontrolled by the taxpayer, of particular products involving intangible property that was licensed or sold by the taxpayer to such uncontrolled party shall be taken fully into account both for determining the taxpayer's apportionment and for determining the apportionment of any other member of a controlled group of corporations to which the taxpayer belongs if the uncontrolled party can reasonably be expected to benefit directly or indirectly (through any member of the controlled group of corporations to which the taxpayer belongs) from the research expense connected with the product category (or categories) of such other member. An uncontrolled party can reasonably be expected to benefit from the research expense of a member of a controlled group of corporations to which the taxpayer belongs if such member can reasonably be expected to license, sell, or transfer intangible property to that uncontrolled party or transfer secret processes to that uncontrolled party, directly or indirectly through a member of the controlled group of corporations to which the taxpayer belongs. Past experience with research and experimentation shall be considered in determining reasonable expectations.

(i) *Definition of uncontrolled party.* For purposes of this paragraph (c)(2) the term *uncontrolled party* means a party that is not a person with a relationship to the taxpayer specified in section 267(b), or is not a member of a controlled group of corporations to which the taxpayer belongs (within the meaning of section 993(a)(3) or 927(d)(4)).

(ii) *Licensed products.* In the case of licensed products, if the amount of sales of such products is unknown (for example, where the licensed product is a component of a large machine), a reasonable estimate based on the principles of section 482 should be made.

(iii) *Sales of intangible property.* In the case of sales of intangible property, regardless of whether the consideration received in exchange for the intangible is a fixed amount or is contingent on the productivity, use, or disposition of the intangible, if the amount of sales of products utilizing the intangible property is unknown, a reasonable estimate of sales shall be made annually. If necessary, appropriate economic analyses shall be used to estimate sales.

(3) *Sales of controlled parties.* For purposes of the apportionment under paragraph (c)(1) of this section, the sales from the product category (or categories) of the taxpayer shall be taken fully into account and the sales from the product category (or categories) of a corporation controlled by the taxpayer shall be taken into account to the extent provided in this paragraph (c)(3) for determining the taxpayer's apportionment, if such corporation can reasonably be expected to benefit directly or indirectly (through another

member of the controlled group of corporations to which the taxpayer belongs) from the taxpayer's research expense connected with the product category (or categories). A corporation controlled by the taxpayer can reasonably be expected to benefit from the taxpayer's research expense if the taxpayer can be expected to license, sell, or transfer intangible property to that corporation or transfer secret processes to that corporation, either directly or indirectly through a member of the controlled group of corporations to which the taxpayer belongs. Past experience with research and experimentation shall be considered in determining reasonable expectations.

(i) *Definition of a corporation controlled by the taxpayer*. For purposes of this paragraph (c)(3), the term *a corporation controlled by the taxpayer* means any corporation that has a relationship to the taxpayer specified in section 267(b) or is a member of a controlled group of corporations to which the taxpayer belongs (within the meaning of section 993(a)(3) or 927(d)(4).

(ii) *Sales to be taken into account*. The sales from the product category (or categories) of a corporation controlled by the taxpayer taken into account shall be equal to the amount of sales that bear the same proportion to the total sales of the controlled corporation as the total value of all classes of the stock of such corporation owned directly or indirectly by the taxpayer, within the meaning of section 1563, bears to the total value of all classes of stock of such corporation.

(iii) *Sales not to be taken into account more than once*. Sales from the product category (or categories) between or among such controlled corporations or the taxpayer shall not be taken into account more than once; in such a situation, the amount sold by the selling corporation to the buying corporation shall be subtracted from the sales of the buying corporation.

(iv) *Effect of cost sharing arrangements*. If the corporation controlled by the taxpayer has entered into a cost sharing arrangement, in accordance with the provisions of § 1.482–7, with the taxpayer for the purpose of developing intangible property, then that corporation shall not reasonably be expected to benefit from the taxpayer's share of the research expense.

(d) *Gross income methods*—(1)(i) *In general*. In lieu of applying the sales method of paragraph (c) of this section, the remaining amount of the deduction for research and experimentation, not apportioned under paragraph (a)(4) or (b)(1)(ii) of this section, shall be apportioned as prescribed in paragraphs (d)(2) and (3) of this section, between the statutory grouping (or among the statutory groupings) of gross income and the residual grouping of gross income.

(ii) *Optional methods to be applied to all research and experimental expenditures*. These optional methods must be applied to the taxpayer's entire deduction for research and experimental expense remaining after applying the exception in paragraph (a)(4) of this section, and may not be applied on a product category basis. Thus, after the allocation of the taxpayer's entire deduction for research and experimental expense under paragraph (a)(2) of this section (by attribution to SIC code categories), the taxpayer must then apportion as necessary the entire deduction as allocated by separate amounts to various product categories, using only the sales method under paragraph (c) of this section or only the optional gross income methods under this paragraph (d). The taxpayer may not use the sales method for a portion of the deduction and optional gross income methods for the remainder of the deduction separately allocated.

(2) *Option one*. The taxpayer may apportion its research and experimental expenditures ratably on the basis of gross income between the statutory grouping (or among the statutory groupings) of gross income and the residual grouping of gross income in the same proportions that the amount of gross income in the statutory grouping (or groupings) and the amount of gross income in the residual grouping bear, respectively, to the total amount of gross income, if the conditions described in paragraph (d)(2)(i) and (ii) of this section are both met.

(i) The amount of research and experimental expense ratably apportioned to the statutory grouping (or groupings in the aggregate) is not less than fifty

percent of the amount that would have been so apportioned if the taxpayer had used the method described in paragraph (c) of this section; and

(ii) The amount of research and experimental expense ratably apportioned to the residual grouping is not less than fifty percent of the amount that would have been so apportioned if the taxpayer had used the method described in paragraph (c) of this section.

(3) *Option two*. If, when the amount of research and experimental expense is apportioned ratably on the basis of gross income, either of the conditions described in paragraph (d)(2)(i) or (ii) of this section is not met, the taxpayer may either—

(i) Where the condition of paragraph (d)(2)(i) of this section is not met, apportion fifty percent of the amount of research and experimental expense that would have been apportioned to the statutory grouping (or groupings in the aggregate) under paragraph (c) of this section to such statutory grouping (or to such statutory groupings in the aggregate and then among such groupings on the basis of gross income within each grouping), and apportion the balance of the amount of research and experimental expenses to the residual grouping; or

(ii) Where the condition of paragraph (d)(2)(ii) of this section is not met, apportion fifty percent of the amount of research and experimental expense that would have been apportioned to the residual grouping under paragraph (c) of this section to such residual grouping, and apportion the balance of the amount of research and experimental expenses to the statutory grouping (or to the statutory groupings in the aggregate and then among such groupings ratably on the basis of gross income within each grouping).

(e) *Binding election*—(1) *In general*. A taxpayer may choose to use either the sales method under paragraph (c) of this section or the optional gross income methods under paragraph (d) of this section for its original return for its first taxable year to which this section applies. The taxpayer's use of either the sales method or the optional gross income methods for its return filed for its first taxable year to which this section applies shall constitute a binding election to use the method chosen for that year and for four taxable years thereafter.

(2) *Change of method*. The taxpayer's election of a method may not be revoked during the period referred to in paragraph (e)(1) of this section without the prior consent of the Commissioner. After the expiration of that period, the taxpayer may change methods without the prior consent of the Commissioner. However, the taxpayer's use of the new method shall constitute a binding election to use the new method for its return filed for the first year for which the taxpayer uses the new method and for four taxable years thereafter. The taxpayer's election of the new method may not be revoked during that period without the prior consent of the Commissioner.

(i) *Short taxable years*. For purposes of this paragraph (e), the term *taxable year* includes a taxable year of less than twelve months.

(ii) *Affiliated groups*. In the case of an affiliated group, the period referred to in paragraph (e)(1) of this section shall commence as of the latest taxable year in which any member of the group has changed methods.

(f) *Special rules for partnerships*—(1) *Research and experimental expenditures*. For purposes of applying this section, if research and experimental expenditures are incurred by a partnership in which the taxpayer is a partner, the taxpayer's research and experimental expenditures shall include the taxpayer's distributive share of the partnership's research and experimental expenditures.

(2) *Purpose and location of expenditures*. In applying the exception for expenditures undertaken to meet legal requirements under paragraph (a)(4) of this section and the exclusive apportionment for the sales method and the optional gross income methods under paragraph (b) of this section, a partner's distributive share of research and experimental expenditures incurred by a partnership shall be treated as incurred by the partner for the same purpose and in the same location as incurred by the partnership.

(3) *Apportionment under the sales method*. In applying the remaining apportionment for the sales method under

paragraph (c) of this section, a taxpayer's sales from a product category shall include the taxpayer's share of any sales from the product category of any partnership in which the taxpayer is a partner. For purposes of the preceding sentence, a taxpayer's share of sales shall be proportionate to the taxpayer's distributive share of the partnership's gross income in the product category.

(g) *Effective date*. This section applies to taxable years beginning after December 31, 1995. However, a taxpayer may at his or her option, apply this section in its entirety to all taxable years beginning after August 1, 1994.

(h) *Examples*. The following examples illustrate the application of this section:

Example 1. (i) *Facts*. X, a domestic corporation, is a manufacturer and distributor of small gasoline engines for lawn mowers. Gasoline engines are a product within the category, Engines and Turbines (SIC Industry Group 351). Y, a wholly owned foreign subsidiary of X, also manufactures and sells these engines abroad. During 1996, X incurred expenditures of $60,000 on research and experimentation, which it deducts as a current expense, to invent and patent a new and improved gasoline engine. All of the research and experimentation was performed in the United States. In 1996, the domestic sales by X of the new engine total $500,000 and foreign sales by Y total $300,000. X provides technology for the manufacture of engines to Y via a license that requires the payment of an arm's length royalty. In 1996, X's gross income is $160,000, of which $140,000 is U.S. source income from domestic sales of gasoline engines and $10,000 is foreign source royalties from Y, and $10,000 is U.S. source interest income.

(ii) *Allocation*. The research and experimental expenditures were incurred in connection with small gasoline engines and they are definitely related to the items of gross income to which the research gives rise, namely gross income from the sale of small gasoline engines in the United States and royalties received from subsidiary Y, a foreign manufacturer of gasoline engines. Accordingly, the expenses are allocable to this class of gross income. The U.S. source interest income is not within this class of gross income and, therefore, is not taken into account.

(iii) *Apportionment*. (A) For purposes of applying the foreign tax credit limitation, the statutory grouping is general limitation gross income from sources without the United States and the residual grouping is gross income from sources within the United States. Since the related class of gross income derived from the use of engine technology consists of both gross income from sources without the United States (royalties from Y) and gross income from sources within the United States (gross income from engine sales), X's deduction of $60,000 for its research and experimental expenditure must be apportioned between the statutory and residual grouping before the foreign tax credit limitation may be determined. Because more than 50 percent of X's research and experimental activity was performed in the United States, 50 percent of that deduction can be apportioned exclusively to the residual grouping of gross income, gross income from sources within the United States. The remaining 50 percent of the deduction can then be apportioned between the residual and statutory groupings on the basis of sales of small gasoline engines by X and Y. Alternatively, X's deduction for research and experimentation can be apportioned under the optional gross income method. The apportionment for 1996 is as follows:

(1) Tentative Apportionment on the Basis of Sales

(*i*) Research and experimental expense to be apportioned between residual and statutory groupings of gross income:	$60,000
(*ii*) Less: Exclusive apportionment of research and experimental expense to the residual grouping of gross income ($60,000 × 50 percent):	$30,000
(*iii*) Research and experimental expense to be apportioned between residual and statutory groupings of gross income on the basis of sales:	$30,000
(*iv*) Apportionment of research and experimental expense to the residual grouping of gross income ($30,000 × $500,000/($500,000 + $300,000)):	$18,750
(*v*) Apportionment of research and experimental expense to the statutory grouping of gross income ($30,000 × $300,000/($500,000 + $300,000)):	$11,250
(*vi*) Total apportioned deduction for research and experimentation:	$60,000
(*vii*) Amount apportioned to the residual grouping ($30,000 + $18,750):	$48,750
(*viii*) Amount apportioned to the statutory grouping:	$11,250

(2) Tentative Apportionment on the Basis of Gross Income.

(*i*) Exclusive apportionment of research and experimental expense to the residual grouping of gross income ($60,000 × 25 percent):	$15,000
(*ii*) Research and experimental expense apportioned to sources within the United States (residual grouping) ($45,000 × $140,000/($140,000 + $10,000)):	$42,000
(*iii*) Research and experimental expense apportioned to sources within country Y (statutory grouping) ($45,000 × $10,000/($140,000 + $10,000)):	$3,000
(*iv*) Amount apportioned to the residual grouping:	$57,000
(*v*) Amount apportioned to the statutory grouping:	$3,000

(B) The total research and experimental expense apportioned to the statutory grouping ($3,000) under the gross income method is approximately 26 percent of the amount apportioned to the statutory grouping under the sales method. Thus, X may use option two of the gross income method (paragraph (d)(3) of this section) and apportion to the statutory grouping fifty percent (50%) of the $11,250 apportioned to that grouping under the sales method. Thus, X apportions $5,625 of research and experimental expense to the statutory grouping. X's use of the optional gross income methods will constitute a binding election to use the optional gross income methods for 1996 and four taxable years thereafter.

Example 2. (i) *Facts.* Assume the same facts as in *Example 1* except that X also spends $30,000 in 1996 for research on steam turbines, all of which is performed in the United States, and X has steam turbine sales in the United States of $400,000. X's foreign subsidiary Y neither manufactures nor sells steam turbines. The steam turbine research is in addition to the $60,000 in research which X does on gasoline engines for lawnmowers. X thus has a deduction of $90,000 for its research activity. X's gross income is $200,000, of which $140,000 is U.S. source income from domestic sales of gasoline engines, $50,000 is U.S. source income from domestic sales of steam turbines, and $10,000 is foreign source royalties from Y.

(ii) *Allocation.* X's research expenses generate income from sales of small gasoline engines and steam turbines. Both of these products are in the same three digit SIC code category, Engines and Turbines (SIC Industry Group 351). Therefore, the deduction is definitely related to this product category and allocable to all items of income attributable to it. These items of X's income are gross income from the sale of small gasoline engines and steam turbines in the United States and royalties from foreign subsidiary Y, a foreign manufacturer and seller of small gasoline engines.

(iii) *Apportionment.* (A) For purposes of applying the foreign tax credit limitation, the statutory grouping is general limitation gross income from sources outside the United States and the residual grouping is gross income from sources within the United States. X's deduction of $90,000 must be apportioned between the statutory and residual groupings. Because more than 50 percent of X's research and experimental activity was performed in the United States, 50 percent of that deduction can be apportioned exclusively to the residual grouping, gross income from sources within the United States. The remaining 50 percent of the deduction can then be apportioned between the residual and statutory groupings on the basis of total sales of small gasoline engines and steam turbines by X and Y. Alternatively, X's deduction for research and experimentation can be apportioned under the optional gross income methods. The apportionment for 1996 is as follows:

(*1*) *Tentative Apportionment on the Basis of Sales*

(*i*) Research and experimental expense to be apportioned between residual and statutory groupings of gross income:	$90,000
(*ii*) Less: Exclusive apportionment of the research and experimental expense to the residual grouping of gross income ($90,000 × 50 percent):	$45,000
(*iii*) Research and experimental expense to be apportioned between the residual and statutory groupings of gross income on the basis of sales:	$45,000
(*iv*) Apportionment of research and experimental expense to the residual grouping of gross income ($45,000 × ($500,000 + $400,000)/($500,000 + $400,000 + $300,000)):	$33,750
(*v*) Apportionment of research and experimental expense to the statutory grouping of gross income ($45,000 × $300,000/($500,000 + $400,000 + $300,000)):	$11,250
(*vi*) Total apportioned deduction for research and experimentation:	$90,000
(*vii*) Amount apportioned to the residual grouping ($45,000 + $33,750):	$78,750
(*viii*) Amount apportioned to the statutory grouping:	$11,250

(*2*) *Tentative Apportionment on the Basis of Gross Income*

(*i*) Exclusive apportionment of research and experimental expense to the residual grouping of gross income ($90,000 × 25 percent):	$22,500
(*ii*) Research and experimental expense apportioned to sources within the United States (residual grouping) ($67,500 × $190,000/($140,000 + $50,000 + $10,000)):	$64,125
(*iii*) Research and experimental expense apportioned to sources within country Y (statutory grouping) ($67,500 × $10,000/($140,000 + $50,000 + $10,000)):	$3,375
(*iv*) Amount apportioned to the residual grouping:	$86,625
(*v*) Amount apportioned to the statutory grouping:	$3,375

(B) The total research and experimental expense apportioned to the statutory grouping ($3,375) under the gross income method is 30 percent of the amount apportioned to the statutory grouping under the sales method. Thus, X may use option two of the gross income method (paragraph (d)(3) of this section) and apportion to the statutory grouping fifty percent (50%) of the $11,250 apportioned to that grouping under the sales method. Thus, X apportions $5,625 of research and experimental expense to the statutory grouping. X's use of the optional gross income methods will constitute a binding election to use the optional gross income methods for 1996 and four taxable years thereafter.

Example 3. (i) *Facts.* Assume the same facts as in *Example 1* except that in 1997 X continues its sales of the new engines, with sales of $600,000 in the United States and $400,000 abroad by subsidiary Y. X also acquires a 60

percent (by value) ownership interest in foreign corporation Z and a 100 percent ownership interest in foreign corporation C. X transfers its engine technology to Z for a royalty equal to 5 percent of sales, and X enters into an arm's length cost-sharing arrangement with C to share the funding of all of X's research activity. In 1997, corporation Z has sales in country Z equal to $1,000,000. X incurs expense of $80,000 on research and experimentation in 1997, and in addition, X performs $15,000 of research on gasoline engines which was funded by the cost-sharing arrangement with C. All of Z's sales are from the product category, Engines and Turbines (SIC Industry Group 351). X performs all of its research in the United States and $20,000 of its expenditure of $80,000 is made solely to meet pollution standards mandated by law. X establishes, to the satisfaction of the Commissioner, that the expenditure in response to pollution standards is not expected to generate gross income (beyond *de minimis* amounts) outside the United States.

(ii) *Allocation*. The $20,000 of research expense which X incurred in connection with pollution standards is definitely related and thus allocable to the residual grouping, gross income from sources within the United States. The remaining $60,000 in research and experimental expenditure incurred by X is definitely related to all gasoline engines and is therefore allocable to the class of gross income to which the engines give rise, gross income from sales of gasoline engines in the United States, royalties from country Y, and royalties from country Z. No part of the $60,000 research expense is allocable to dividends from country C, because corporation C has already paid, through its cost-sharing arrangement, for research activity performed by X which may benefit C.

(iii) *Apportionment*. For purposes of applying the foreign tax credit limitation, the statutory grouping is general limitation gross income from sources without the United States, and the residual grouping is gross income from sources within the United States. X's deduction of $60,000 for its research and experimental expenditure must be apportioned between these groupings. Because more than 50 percent of the research and experimentation was performed in the United States, 50 percent of the $60,000 deduction can be apportioned exclusively to the residual grouping. The remaining 50 percent of the deduction can then be apportioned between the residual and the statutory grouping on the basis of sales of gasoline engines by X, Y, and Z. (If X utilized the optional gross income methods in 1996, then its use of such methods constituted a binding election to use the optional gross income methods in 1996 and for four taxable years thereafter. If X utilized the sales method in 1996, then its use of such method constituted a binding election to use the sales method in 1996 and for four taxable years thereafter.) The optional gross income methods are not illustrated in this *Example 3* (see instead *Examples 1* and *2*). Since X has only a 60 percent ownership interest in corporation Z, only 60 percent of Z's sales (60% of $1,000,000, or $600,000) are included for purposes of apportionment. The allocation and apportionment for 1997 is as follows:

(A) X's total research expense:	$80,000
(B) Less: Legally mandated research directly allocated to the residual grouping of gross income:	$20,000
(C) Tentative apportionment on the basis of sales.	
(*1*) Research and experimental expense to be apportioned between residual and statutory groupings of gross income:	$60,000
(*2*) Less: Exclusive apportionment of research and experimental expense to the residual grouping of gross income ($60,000 × 50 percent):	$30,000
(*3*) Research and experimental expense to be apportioned between the residual and the statutory groupings on the basis of sales:	$30,000
(*4*) Apportionment of research and experimental expense to gross income from sources within the United States (residual grouping) ($30,000 × $600,000/($600,000 + $400,000 + $600,000)):	$11,250
(*5*) Apportionment of research and experimental expense to general limitation gross income from countries Y and Z (statutory grouping) ($30,000 × $400,000 + $600,000/($600,000 + $400,000 + $600,000)):	$18,750
(*6*) Total apportioned deduction for research and experimentation ($30,000 + $30,000):	$60,000
(*7*) Amount apportioned to the residual grouping ($30,000 + $11,250):	$41,250
(*8*) Amount apportioned to the statutory grouping of gross income from sources within countries Y and Z:	$18,750

Example 4. Research and Experimentation (i) *Facts*. X, a domestic corporation, manufactures and sells forklift trucks and other types of materials handling equipment in the United States. The manufacture and sale of forklift trucks and other materials handling equipment belongs to the product category, Construction, Mining, and Materials Handling Machinery and Equipment (SIC Industry Group 353). X also sells its forklift trucks to a wholesaling subsidiary located in foreign country Y (but title passes in the United States), and X manufactures forklift trucks in foreign country Z. The wholesaling of forklift trucks to country Y also belongs to X's product category Transportation equipment and, therefore, may not belong to the product category, Wholesale trade (SIC Major Group 50 and 51). In 1997, X sold $7,000,000 of forklift trucks to purchasers in the United States, $3,000,000 of forklift trucks to the wholesaling subsidiary in Y, and transferred forklift truck components with an FOB export value of $2,000,000 to its branch in Z. The branch's sales of finished forklift trucks were $5,000,000. In response to legally mandated emission control requirements, X's United States research department has been engaged in a research project to improve the performance and quality of

engine exhaust systems used on its products in the United States. It incurs expenses of $100,000 for this purpose in 1997. In the past, X has customarily adapted the product improvements developed originally for the domestic market to its forklift trucks manufactured abroad. During the taxable year 1997, development of an improved engine exhaust system is completed and X begins installing the new system during the latter part of the taxable year in products manufactured and sold in the United States. X continues to manufacture and sell forklift trucks in foreign countries without the improved engine exhaust systems.

(ii) *Allocation.* X's deduction for its research expense is definitely related to the income to which it gives rise, namely income from the manufacture and sale of forklift trucks within the United States and in country Z. Although the research is undertaken in response to a legal mandate, it can reasonably be expected to generate gross income from the manufacture and sale of trucks by the branch in Z. Therefore, the deduction is not allocable solely to income from X's domestic sales of forklift trucks. It is allocable to income from such sales and income from the sales of X's branch in Z.

(iii) *Apportionment.* For the method of apportionment on the basis of either sales or gross income, see *Example 3.* However, in determining the amount of research apportioned to income from foreign and domestic sources, the net sales of the branch in Z are $3,000,000 ($5,000,000 less $2,000,000) and the sales within the United States are $12,000,000 ($7,000,000 plus $3,000,000 plus $2,000,000). See § 1.861–17(c)(3)(iii).

Example 5. (i) *Facts.* X, a domestic corporation, is a drug company that manufactures a wide variety of pharmaceutical products for sale in the United States. Pharmaceutical products belong to the product category, Drugs (SIC Industry Group 283). X exports its pharmaceutical products through a foreign sales corporation (FSC). X's wholly owned foreign subsidiary Y also manufactures pharmaceutical products. In 1997, X has domestic sales of pharmaceutical products of $10,000,000, the FSC has sales of pharmaceutical products of $3,000,000, and Y has sales of pharmaceutical products of $5,000,000. In that same year, 1997, X incurs expense of $200,000 on research to test a product in response to requirements imposed by the United States Food and Drug Administration (FDA). X is able to show that, even though country Y imposes certain testing requirements on pharmaceutical products, the research performed in the United States is not accepted by country Y for purposes of its own licensing requirements, and the research has minimal use abroad. X is further able to show that FSC sells goods to countries that do not accept or do not require research performed in the United States for purposes of their own licensing standards.

(ii) *Allocation.* Since X's research expense of $200,000 is undertaken to meet the requirements of the United States Food and Drug Administration, and since it is reasonable to expect that the expenditure will not generate gross income (beyond *de minimis* amounts) outside the United States, the deduction is definitely related and thus allocable to the residual grouping.

(iii) *Apportionment.* No apportionment is necessary since the entire expense is allocated to the residual grouping, gross income from sales within the United States.

Example 6. (i) *Facts.* X, a domestic corporation, is engaged in continuous research and experimentation to improve the quality of the products that it manufactures and sells, which are floodlights, flashlights, fuse boxes, and solderless connectors. X incurs and deducts $100,000 of expenditure for research and experimentation in 1997 that was performed exclusively in the United States. As a result of this research activity, X acquires patents that it uses in its own manufacturing activity. X licenses its floodlight patent to Y and Z, uncontrolled foreign corporations, for use in their own territories, countries Y and Z, respectively. Corporation Y pays X an arm's length royalty of $3,000 plus $0.20 for each floodlight sold. Sales of floodlights by Y for the taxable year are $135,000 (at $4.50 per unit) or 30,000 units, and the royalty is $9,000 ($3,000 + $0.20 × 30,000). Y has sales of other products of $500,000. Z pays X an arm's length royalty of $3,000 plus $0.30 for each unit sold. Z manufactures 30,000 floodlights in the taxable year, and the royalty is $12,000 ($3,000 + $0.30 × 30,000). The dollar value of Z's floodlight sales is not known and cannot be reasonably estimated because, in this case, the floodlights are not sold separately by Z but are instead used as a component in Z's manufacture of lighting equipment for theaters. The sales of all Z's products, including the lighting equipment for theaters, are $1,000,000. Y and Z each sell the floodlights exclusively within their respective countries. X's sales of floodlights for the taxable year are $500,000 and its sales of its other products, flashlights, fuse boxes, and solderless connectors, are $400,000. X has gross income of $500,000, consisting of gross income from domestic sources from sales of floodlights, flashlights, fuse boxes, and solderless connectors of $479,000, and royalty income of $9,000 and $12,000 from foreign corporations Y and Z respectively. X utilized the optional gross income methods of apportionment for its return filed for its first taxable year to which this section applies.

(ii) *Allocation.* X's research and experimental expenses are definitely related to all of the products that it produces, which are floodlights, flashlights, fuse boxes, and solderless connectors. All of these products

are in the same three digit SIC Code category, Electric Lighting and Wiring Equipment (SIC Industry Group 364). Thus, X's research and experimental expenses are allocable to all items of income attributable to this product category, domestic sales income and royalty income from the foreign countries in which corporations Y and Z operate.

(iii) *Apportionment.* (A) The statutory grouping of gross income is general limitation income from sources without the United States. The residual grouping is gross income from sources within the United States. X's deduction of $100,000 for its research expenditures must be apportioned between the groupings. For apportionment on the basis of sales in accordance with paragraph (c) of this section, X is entitled to an exclusive apportionment of 50 percent of its research and experimental expense to the residual grouping, gross income from sources within the United States, since more than 50 percent of the research activity was performed in the United States. The remaining 50 percent of the deduction can then be apportioned between the residual and statutory groupings on the basis of sales. Since Y and Z are unrelated licensees of X, only their sales of the licensed product, floodlights, are included for purposes of apportionment. Floodlight sales of Z are unknown, but are estimated at ten times royalties from Z, or $120,000. All of X's sales from the entire product category are included for purposes of apportionment on the basis of sales. Alternatively, X may apportion its deduction on the basis of gross income, in accordance with paragraph (d) of this section. The apportionment is as follows:

(1) Tentative Apportionment on the Basis of Sales

(*i*) Research and experimental expense to be apportioned between statutory and residual groupings of gross income:	$100,000
(*ii*) Less: Exclusive apportionment of research and experimental expense to the residual groupings of gross income ($100,000 × 50 percent):	$50,000
(*iii*) Research and experimental expense to be apportioned between the statutory and residual groupings of gross income on the basis of sales:	$50,000
(*iv*) Apportionment of research and experimental expense to the residual groupings of gross income ($50,000 × $900,000/($900,000 + $135,000 + $120,000)):	$38,961
(*v*) Apportionment of research and experimental expense to the statutory grouping, royalty income from countries Y and Z ($50,000 × $135,000 + $120,000/($900,000 + $135,000 + $120,000)):	$11,039
(*vi*) Total apportioned deduction for research and experimentation:	$100,000
(*vii*) Amount apportioned to the residual grouping ($50,000 + $38,961):	$88,961
(*viii*) Amount apportioned to the statutory grouping of sources within countries Y and Z:	$11,039

(2) Tentative Apportionment on Gross Income Basis

(*i*) Exclusive apportionment of research and experimental expense to the residual grouping of gross income ($100,000 × 25 percent):	$25,000
(*ii*) Apportionment of research and experimental expense to the residual grouping of gross income ($75,000 × $479,000/$500,000):	$71,850
(*iii*) Apportionment of research and experimental expense to the statutory grouping of gross income ($75,000 × $9,000 + $12,000/$500,000):	$3,150
(*iv*) Amount apportioned to the residual grouping:	$96,850
(*v*) Amount apportioned to the statutory grouping of general limitation income from sources without the United States:	$3,150

(B) Since X has elected to use the optional gross income methods of apportionment and its apportionment on the basis of gross income to the statutory grouping, $3,150, is less than 50 percent of its apportionment on the basis of sales to the statutory grouping, $11,039, it must use Option two of paragraph (d)(3) of this section and apportion $5,520 (50 percent of $11,039) to the statutory grouping.

[T.D. 8646, 60 FR 66503, Dec. 22, 1995, as amended by T.D. 9441, 74 FR 390, Jan. 5, 2009; T.D. 9568, 76 FR 80136, Dec. 22, 2011]

§ 1.861–18 Classification of transactions involving computer programs.

(a) *General*—(1) *Scope.* This section provides rules for classifying transactions relating to computer programs for purposes of subchapter N of chapter 1 of the Internal Revenue Code, sections 367, 404A, 482, 551, 679, 1059A, chapter 3, chapter 5, sections 842 and 845 (to the extent involving a foreign person), and transfers to foreign trusts not covered by section 679.

(2) *Categories of transactions.* This section generally requires that such transactions be treated as being solely within one of four categories (described in paragraph (b)(1) of this section) and provides certain rules for categorizing such transactions. In the case of a transfer of a copyright right, this section provides rules for determining whether the transaction should be classified as either a sale or exchange, or a license generating royalty income. In the case of a transfer of a copyrighted article, this section provides rules for determining whether the transaction should be classified as either a sale or exchange, or a lease generating rental income.

(3) *Computer program.* For purposes of this section, a computer program is a set of statements or instructions to be

used directly or indirectly in a computer in order to bring about a certain result. For purposes of this paragraph (a)(3), a computer program includes any media, user manuals, documentation, data base or similar item if the media, user manuals, documentation, data base or similar item is incidental to the operation of the computer program.

(b) *Categories of transactions*—(1) *General.* Except as provided in paragraph (b)(2) of this section, a transaction involving the transfer of a computer program, or the provision of services or of know-how with respect to a computer program (collectively, a transfer of a computer program) is treated as being solely one of the following—

(i) A transfer of a copyright right in the computer program;

(ii) A transfer of a copy of the computer program (a copyrighted article);

(iii) The provision of services for the development or modification of the computer program; or

(iv) The provision of know-how relating to computer programming techniques.

(2) *Transactions consisting of more than one category.* Any transaction involving computer programs which consists of more than one of the transactions described in paragraph (b)(1) of this section shall be treated as separate transactions, with the appropriate provisions of this section being applied to each such transaction. However, any transaction that is de minimis, taking into account the overall transaction and the surrounding facts and circumstances, shall not be treated as a separate transaction, but as part of another transaction.

(c) *Transfers involving copyright rights and copyrighted articles*—(1) *Classification*—(i) *Transfers treated as transfers of copyright rights.* A transfer of a computer program is classified as a transfer of a copyright right if, as a result of the transaction, a person acquires any one or more of the rights described in paragraphs (c)(2)(i) through (iv) of this section. Whether the transaction is treated as being solely the transfer of a copyright right or is treated as separate transactions is determined pursuant to paragraph (b)(1) and (b)(2) of this section. For example, if a person receives a disk containing a copy of a computer program which enables it to exercise, in relation to that program, a non-de minimis right described in paragraphs (c)(2)(i) through (iv) of this section (and the transaction does not involve, or involves only a de minimis provision of services as described in paragraph (d) of this section or of know-how as described in paragraph (e) of this section), then, under paragraph (b)(2) of this section, the transfer is classified solely as a transfer of a copyright right.

(ii) *Transfers treated solely as transfers of copyrighted articles.* If a person acquires a copy of a computer program but does not acquire any of the rights described in paragraphs (c)(2)(i) through (iv) of this section (or only acquires a de minimis grant of such rights), and the transaction does not involve, or involves only a de minimis, provision of services as described in paragraph (d) of this section or of know-how as described in paragraph (e) of this section, the transfer of the copy of the computer program is classified solely as a transfer of a copyrighted article.

(2) *Copyright rights.* The copyright rights referred to in paragraph (c)(1) of this section are as follows—

(i) The right to make copies of the computer program for purposes of distribution to the public by sale or other transfer of ownership, or by rental, lease or lending;

(ii) The right to prepare derivative computer programs based upon the copyrighted computer program;

(iii) The right to make a public performance of the computer program; or

(iv) The right to publicly display the computer program.

(3) *Copyrighted article.* A copyrighted article includes a copy of a computer program from which the work can be perceived, reproduced, or otherwise communicated, either directly or with the aid of a machine or device. The copy of the program may be fixed in the magnetic medium of a floppy disk, or in the main memory or hard drive of a computer, or in any other medium.

(d) *Provision of services.* The determination of whether a transaction involving a newly developed or modified computer program is treated as either

the provision of services or another transaction described in paragraph (b)(1) of this section is based on all the facts and circumstances of the transaction, including, as appropriate, the intent of the parties (as evidenced by their agreement and conduct) as to which party is to own the copyright rights in the computer program and how the risks of loss are allocated between the parties.

(e) *Provision of know-how.* The provision of information with respect to a computer program will be treated as the provision of know-how for purposes of this section only if the information is—

(1) Information relating to computer programming techniques;

(2) Furnished under conditions preventing unauthorized disclosure, specifically contracted for between the parties; and

(3) Considered property subject to trade secret protection.

(f) *Further classification of transfers involving copyright rights and copyrighted articles*—(1) *Transfers of copyright rights.* The determination of whether a transfer of a copyright right is a sale or exchange of property is made on the basis of whether, taking into account all facts and circumstances, there has been a transfer of all substantial rights in the copyright. A transaction that does not constitute a sale or exchange because not all substantial rights have been transferred will be classified as a license generating royalty income. For this purpose, the principles of sections 1222 and 1235 may be applied. Income derived from the sale or exchange of a copyright right will be sourced under section 865(a), (c), (d), (e), or (h), as appropriate. Income derived from the licensing of a copyright right will be sourced under section 861(a)(4) or 862(a)(4), as appropriate.

(2) *Transfers of copyrighted articles.* The determination of whether a transfer of a copyrighted article is a sale or exchange is made on the basis of whether, taking into account all facts and circumstances, the benefits and burdens of ownership have been transferred. A transaction that does not constitute a sale or exchange because insufficient benefits and burdens of ownership of the copyrighted article have been transferred, such that a person other than the transferee is properly treated as the owner of the copyrighted article, will be classified as a lease generating rental income. Income from transactions that are classified as sales or exchanges of copyrighted articles will be sourced under sections 861(a)(6), 862(a)(6), 863, 865(a), (b), (c), or (e), as appropriate. Income derived from the leasing of a copyrighted article will be sourced under section 861(a)(4) or section 862(a)(4), as appropriate.

(3) *Special circumstances of computer programs.* In connection with determinations under this paragraph (f), consideration must be given as appropriate to the special characteristics of computer programs in transactions that take advantage of these characteristics (such as the ability to make perfect copies at minimal cost). For example, a transaction in which a person acquires a copy of a computer program on disk subject to a requirement that the disk be destroyed after a specified period is generally the equivalent of a transaction subject to a requirement that the disk be returned after such period. Similarly, a transaction in which the program deactivates itself after a specified period is generally the equivalent of returning the copy.

(g) *Rules of operation*—(1) *Term applied to transaction by parties.* Neither the form adopted by the parties to a transaction, nor the classification of the transaction under copyright law, shall be determinative. Therefore, for example, if there is a transfer of a computer program on a single disk for a one-time payment with restrictions on transfer and reverse engineering, which the parties characterize as a license (including, but not limited to, agreements commonly referred to as shrink-wrap licenses), application of the rules of paragraphs (c) and (f) of this section may nevertheless result in the transaction being classified as the sale of a copyrighted article.

(2) *Means of transfer not to be taken into account.* The rules of this section shall be applied irrespective of the physical or electronic or other medium used to effectuate a transfer of a computer program.

(3) *To the public*—(i) *In general.* For purposes of paragraph (c)(2)(i) of this section, a transferee of a computer program shall not be considered to have the right to distribute copies of the program to the public if it is permitted to distribute copies of the software to only either a related person, or to identified persons who may be identified by either name or by legal relationship to the original transferee. For purposes of this subparagraph, a related person is a person who bears a relationship to the transferee specified in section 267(b)(3), (10), (11), or (12), or section 707(b)(1)(B). In applying section 267(b), 267(f), 707(b)(1)(B), or 1563(a), ''10 percent'' shall be substituted for ''50 percent.''

(ii) *Use by individuals.* The number of employees of a transferee of a computer program who are permitted to use the program in connection with their employment is not relevant for purposes of this paragraph (g)(3). In addition, the number of individuals with a contractual agreement to provide services to the transferee of a computer program who are permitted to use the program in connection with the performance of those services is not relevant for purposes of this paragraph (g)(3).

(h) *Examples.* The provisions of this section may be illustrated by the following examples:

Example 1. (i) *Facts.* Corp A, a U.S. corporation, owns the copyright in a computer program, Program X. It copies Program X onto disks. The disks are placed in boxes covered with a wrapper on which is printed what is generally referred to as a shrink-wrap license. The license is stated to be perpetual. Under the license no reverse engineering, decompilation, or disassembly of the computer program is permitted. The transferee receives, first, the right to use the program on two of its own computers (for example, a laptop and a desktop) provided that only one copy is in use at any one time, and, second, the right to make one copy of the program on each machine as an essential step in the utilization of the program. The transferee is permitted by the shrink-wrap license to sell the copy so long as it destroys any other copies it has made and imposes the same terms and conditions of the license on the purchaser of its copy. These disks are made available for sale to the general public in Country Z. In return for valuable consideration, P, a Country Z resident, receives one such disk.

(ii) *Analysis.* (A) Under paragraph (g)(1) of this section, the label license is not determinative. None of the copyright rights described in paragraph (c)(2) of this section have been transferred in this transaction. P has received a copy of the program, however, and, therefore, under paragraph (c)(1)(ii) of this section, P has acquired solely a copyrighted article.

(B) Taking into account all of the facts and circumstances, P is properly treated as the owner of a copyrighted article. Therefore, under paragraph (f)(2) of this section, there has been a sale of a copyrighted article rather than the grant of a lease.

Example 2. (i) *Facts.* The facts are the same as those in *Example 1,* except that instead of selling disks, Corp A, the U.S. corporation, decides to make Program X available, for a fee, on a World Wide Web home page on the Internet. P, the Country Z resident, in return for payment made to Corp A, downloads Program X (via modem) onto the hard drive of his computer. As part of the electronic communication, P signifies his assent to a license agreement with terms identical to those in *Example 1,* except that in this case P may make a back-up copy of the program on to a disk.

(ii) *Analysis.* (A) None of the copyright rights described in paragraph (c)(2) of this section have passed to P. Although P did not buy a physical copy of the disk with the program on it, paragraph (g)(2) of this section provides that the means of transferring the program is irrelevant. Therefore, P has acquired a copyrighted article.

(B) As in *Example 1,* P is properly treated as the owner of a copyrighted article. Therefore, under paragraph (f)(2) of this section, there has been a sale of a copyrighted article rather than the grant of a lease.

Example 3. (i) *Facts.* The facts are the same as those in *Example 1,* except that Corp A only allows P, the Country Z resident, to use Program X for one week. At the end of that week, P must return the disk with Program X on it to Corp A. P must also destroy any copies made of Program X. If P wishes to use Program X for a further period he must enter into a new agreement to use the program for an additional charge.

(ii) *Analysis.* (A) Under paragraph (c)(2) of this section, P has received no copyright rights. Because P has received a copy of the program under paragraph (c)(1)(ii) of this section, he has, therefore, received a copyrighted article.

(B) Taking into account all of the facts and circumstances, P is not properly treated as the owner of a copyrighted article. Therefore, under paragraph (f)(2) of this section, there has been a lease of a copyrighted article rather than a sale. Taking into account the special characteristics of computer programs as provided in paragraph (f)(3) of this section, the result would be the same if P

were required to destroy the disk at the end of the one week period instead of returning it since Corp A can make additional copies of the program at minimal cost.

Example 4. (i) *Facts.* The facts are the same as those in *Example 2,* where P, the Country Z resident, receives Program X from Corp A's home page on the Internet, except that P may only use Program X for a period of one week at the end of which an electronic lock is activated and the program can no longer be accessed. Thereafter, if P wishes to use Program X, it must return to the home page and pay Corp A to send an electronic key to reactivate the program for another week.

(ii) *Analysis.* (A) As in *Example 3,* under paragraph (c)(2) of this section, P has not received any copyright rights. P has received a copy of the program, and under paragraph (g)(2) of this section, the means of transmission is irrelevant. P has, therefore, under paragraph (c)(1)(ii) of this section, received a copyrighted article.

(B) As in *Example 3,* P is not properly treated as the owner of a copyrighted article. Therefore, under paragraph (f)(2) of this section, there has been a lease of a copyrighted article rather than a sale. While P does retain Program X on its computer at the end of the one week period, as a legal matter P no longer has the right to use the program (without further payment) and, indeed, cannot use the program without the electronic key. Functionally, Program X is no longer on the hard drive of P's computer. Instead, the hard drive contains only a series of numbers which no longer perform the function of Program X. Although in *Example 3,* P was required to physically return the disk, taking into account the special characteristics of computer programs as provided in paragraph (f)(3) of this section, the result in this *Example 4* is the same as in *Example 3.*

Example 5. (i) *Facts.* Corp A, a U.S. corporation, transfers a disk containing Program X to Corp B, a Country Z corporation, and grants Corp B an exclusive license for the remaining term of the copyright to copy and distribute an unlimited number of copies of Program X in the geographic area of Country Z, prepare derivative works based upon Program X, make public performances of Program X, and publicly display Program X. Corp B will pay Corp A a royalty of $y a year for three years, which is the expected period during which Program X will have commercially exploitable value.

(ii) *Analysis.* (A) Although Corp A has transferred a disk with a copy of Program X on it to Corp B, under paragraph (c)(1)(i) of this section because this transfer is accompanied by a copyright right identified in paragraph (c)(2)(i) of this section, this transaction is a transfer solely of copyright rights, not of copyrighted articles. For purposes of paragraph (b)(2) of this section, the disk containing a copy of Program X is a de minimis component of the transaction.

(B) Applying the all substantial rights test under paragraph (f)(1) of this section, Corp A will be treated as having sold copyright rights to Corp B. Corp B has acquired all of the copyright rights in Program X, has received the right to use them exclusively within Country Z, and has received the rights for the remaining life of the copyright in Program X. The fact the payments cease before the copyright term expires is not controlling. Under paragraph (g)(1) of this section, the fact that the agreement is labelled a license is not controlling (nor is the fact that Corp A receives a sum labelled a royalty). (The result in this case would be the same if the copy of Program X to be used for the purposes of reproduction were transmitted electronically to Corp B, as a result of the application of the rule of paragraph (g)(2) of this section.)

Example 6. (i) *Facts.* Corp A, a U.S. corporation, transfers a disk containing Program X to Corp B, a Country Z corporation, and grants Corp B the non exclusive right to reproduce (either directly or by contracting with either Corp A or another person to do so) and distribute for sale to the public an unlimited number of disks at its factory in Country Z in return for a payment related to the number of disks copied and sold. The term of the agreement is two years, which is less than the remaining life of the copyright.

(ii) *Analysis.* (A) As in *Example 5,* the transfer of the disk containing the copy of the program does not constitute the transfer of a copyrighted article under paragraph (c)(1) of this section because Corp B has also acquired a copyright right under paragraph (c)(2)(i) of this section, the right to reproduce and distribute to the public. For purposes of paragraph (b)(2) of this section, the disk containing Program X is a de minimis component of the transaction.

(B) Taking into account all of the facts and circumstances, there has been a license of Program X to Corp B, and the payments made by Corp B are royalties. Under paragraph (f)(1) of this section, there has not been a transfer of all substantial rights in the copyright to Program X because Corp A has the right to enter into other licenses with respect to the copyright of Program X, including licenses in Country Z (or even to sell that copyright, subject to Corp B's interest). Corp B has acquired no right itself to license the copyright rights in Program X. Finally, the term of the license is for less than the remaining life of the copyright in Program X.

Example 7. (i) *Facts.* Corp C, a distributor in Country Z, enters into an agreement with Corp A, a U.S. corporation, to purchase as many copies of Program X on disk as it may from time-to-time request. Corp C will then sell these disks to retailers. The disks are

shipped in boxes covered by shrink-wrap licenses (identical to the license described in Example 1).

(ii) *Analysis.* (A) Corp C has not acquired any copyright rights under paragraph (c)(2) of this section with respect to Program X. It has acquired individual copies of Program X, which it may sell to others. The use of the term license is not dispositive under paragraph (g)(1) of this section. Under paragraph (c)(1)(ii) of this section, Corp C has acquired copyrighted articles.

(B) Taking into account all of the facts and circumstances, Corp C is properly treated as the owner of copyrighted articles. Therefore, under paragraph (f)(2) of this section, there has been a sale of copyrighted articles.

Example 8. (i) *Facts.* Corp A, a U.S. corporation, transfers a disk containing Program X to Corp D, a foreign corporation engaged in the manufacture and sale of personal computers in Country Z. Corp A grants Corp D the non-exclusive right to copy Program X onto the hard drive of an unlimited number of computers, which Corp D manufactures, and to distribute those copies (on the hard drive) to the public. The term of the agreement is two years, which is less than the remaining life of the copyright in Program X. Corp D pays Corp A an amount based on the number of copies of Program X it loads on to computers.

(ii) *Analysis.* The analysis is the same as in *Example 6.* Under paragraph (c)(2)(i) of this section, Corp D has acquired a copyright right enabling it to exploit Program X by copying it on to the hard drives of the computers that it manufactures and then sells. For purposes of paragraph (b)(2) of this section, the disk containing Program X is a de minimis component of the transaction. Taking into account all of the facts and circumstances, Corp D has not, however, acquired all substantial rights in the copyright to Program X (for example, the term of the agreement is less than the remaining life of the copyright). Under paragraph (f)(1) of this section, this transaction is, therefore, a license of Program X to Corp D rather than a sale and the payments made by Corp D are royalties. (The result would be the same if Corp D included with the computers it sells an archival copy of Program X on a floppy disk.)

Example 9. (i) *Facts.* The facts are the same as in *Example 8,* except that Corp D, the Country Z corporation, receives physical disks. The disks are shipped in boxes covered by shrink-wrap licenses (identical to the licenses described in *Example 1*). The terms of these licenses do not permit Corp D to make additional copies of Program X. Corp D uses each individual disk only once to load a single copy of Program X onto each separate computer. Corp D transfers the disk with the computer when it is sold.

(ii) *Analysis.* (A) As in *Example 7* (unlike *Example 8*) no copyright right identified in paragraph (c)(2) of this section has been transferred. Corp D acquires the disks without the right to reproduce and distribute publicly further copies of Program X. This is therefore the transfer of copyrighted articles under paragraph (c)(1)(ii) of this section.

(B) Taking into account all of the facts and circumstances, Corp D is properly treated as the owner of copyrighted articles. Therefore, under paragraph (f)(2) of this section, the transaction is classified as the sale of a copyrighted article. (The result would be the same if Corp D used a single physical disk to copy Program X onto each computer, and transferred an unopened box containing Program X with each computer, if Corp D were not permitted to copy Program X onto more computers than the number of individual copies purchased.)

Example 10. (i) *Facts.* Corp A, a U.S. corporation, transfers a disk containing Program X to Corp E, a Country Z corporation, and grants Corp E the right to load Program X onto 50 individual workstations for use only by Corp E employees at one location in return for a one-time per-user fee (generally referred to as a site license or enterprise license). If additional workstations are subsequently introduced, Program X may be loaded onto those machines for additional one-time per-user fees. The license which grants the rights to operate Program X on 50 workstations also prohibits Corp E from selling the disk (or any of the 50 copies) or reverse engineering the program. The term of the license is stated to be perpetual.

(ii) *Analysis.* (A) The grant of a right to copy, unaccompanied by the right to distribute those copies to the public, is not the transfer of a copyright right under paragraph (c)(2) of this section. Therefore, under paragraph (c)(1)(ii) of this section, this transaction is a transfer of copyrighted articles (50 copies of Program X).

(B) Taking into account all of the facts and circumstances, P is properly treated as the owner of copyrighted articles. Therefore, under paragraph (f)(2) of this section, there has been a sale of copyrighted articles rather than the grant of a lease. Notwithstanding the restriction on sale, other factors such as, for example, the risk of loss and the right to use the copies in perpetuity outweigh, in this case, the restrictions placed on the right of alienation.

(C) The result would be the same if Corp E were permitted to copy Program X onto an unlimited number of workstations used by employees of either Corp E or corporations that had a relationship to Corp E specified in paragraph (g)(3) of this section.

Example 11. (i) *Facts.* The facts are the same as in *Example 10,* except that Corp E, the Country Z corporation, acquires the right to make Program X available to

workstation users who are Corp E employees by way of a local area network (LAN). The number of users that can use Program X on the LAN at any one time is limited to 50. Corp E pays a one-time fee for the right to have up to 50 employees use the program at the same time.

(ii) *Analysis.* Under paragraph (g)(2) of this section the mode of utilization is irrelevant. Therefore, as in *Example 10,* under paragraph (c)(2) of this section, no copyright right has been transferred, and, thus, under paragraph (c)(1)(ii) of this section, this transaction will be classified as the transfer of a copyrighted article. Under the benefits and burdens test of paragraph (f)(2) of this section, this transaction is a sale of copyrighted articles. The result would be the same if an unlimited number of Corp E employees were permitted to use Program X on the LAN or if Corp E were permitted to copy Program X onto LANs maintained by corporations that had a relationship to Corp E specified in paragraph (g)(3) of this section.

Example 12. (i) *Facts.* The facts are the same as in *Example 11,* except that Corp E pays a monthly fee to Corp A, the U.S. corporation, calculated with reference to the permitted maximum number of users (which can be changed) and the computing power of Corp E's server. In return for this monthly fee, Corp E receives the right to receive upgrades of Program X when they become available. The agreement may be terminated by either party at the end of any month. When the disk containing the upgrade is received, Corp E must return the disk containing the earlier version of Program X to Corp A. If the contract is terminated, Corp E must delete (or otherwise destroy) all copies made of the current version of Program X. The agreement also requires Corp A to provide technical support to Corp E but the agreement does not allocate the monthly fee between the right to receive upgrades of Program X and the technical support services. The amount of technical support that Corp A will provide to Corp E is not foreseeable at the time the contract is entered into but is expected to be de minimis. The agreement specifically provides that Corp E has not thereby been granted an option to purchase Program X.

(ii) *Analysis.* (A) Corp E has received no copyright rights under paragraph (c)(2) of this section. Corp A has not provided any services described in paragraph (d) of this section. Based on all the facts and circumstances of the transaction, Corp A has provided de minimis technical services to Corp E. Therefore, under paragraph (c)(1)(ii) of this section, the transaction is a transfer of a copyrighted article.

(B) Taking into account all facts and circumstances, under the benefits and burdens test Corp E is not properly treated as the owner of the copyrighted article. Corp E does not receive the right to use Program X in perpetuity, but only for so long as it continues to make payments. Corp E does not have the right to purchase Program X on advantageous (or, indeed, any) terms once a certain amount of money has been paid to Corp A or a certain period of time has elapsed (which might indicate a sale). Once the agreement is terminated, Corp E will no longer possess any copies of Program X, current or superseded. Therefore under paragraph (f)(2) of this section there has been a lease of a copyrighted article.

Example 13. (i) *Facts.* The facts are the same as in *Example 12,* except that, while Corp E must return copies of Program X as new upgrades are received, if the agreement terminates, Corp E may keep the latest version of Program X (although Corp E is still prohibited from selling or otherwise transferring any copy of Program X).

(ii) *Analysis.* For the reasons stated in *Example 10,* paragraph (ii)(B), the transfer of the program will be treated as a sale of a copyrighted article rather than as a lease.

Example 14. (i) *Facts.* Corp G, a Country Z corporation, enters into a contract with Corp A, a U.S. corporation, for Corp A to modify Program X so that it can be used at Corp G's facility in Country Z. Under the contract, Corp G is to acquire one copy of the program on a disk and the right to use the program on 5,000 workstations. The contract requires Corp A to rewrite elements of Program X so that it will conform to Country Z accounting standards and states that Corp A retains all copyright rights in the modified Program X. The agreement between Corp A and Corp G is otherwise identical as to rights and payment terms as the agreement described in *Example 10.*

(ii) *Analysis.* (A) As in *Example 10,* no copyright rights are being transferred under paragraph (c)(2) of this section. In addition, since no copyright rights are being transferred to Corp G, this transaction does not involve the provision of services by Corp A under paragraph (d) of this section. This transaction will be classified, therefore, as a transfer of copyrighted articles under paragraph (c)(1)(ii) of this section.

(B) Taking into account all facts and circumstances, Corp G is properly treated as the owner of copyrighted articles. Therefore, under paragraph (f)(2) of this section, there has been the sale of a copyrighted article rather than the grant of a lease.

Example 15. (i) *Facts.* Corp H, a Country Z corporation, enters into a license agreement for a new computer program. Program Q is to be written by Corp A, a U.S. corporation. Corp A and Corp H agree that Corp A is writing Program Q for Corp H and that, when Program Q is completed, the copyright in Program Q will belong to Corp H. Corp H gives instructions to Corp A programmers regarding program specifications. Corp H

agrees to pay Corp A a fixed monthly sum during development of the program. If Corp H is dissatisfied with the development of the program, it may cancel the contract at the end of any month. In the event of termination, Corp A will retain all payments, while any procedures, techniques or copyrightable interests will be the property of Corp H. All of the payments are labelled royalties. There is no provision in the agreement for any continuing relationship between Corp A and Corp H, such as the furnishing of updates of the program, after completion of the modification work.

(ii) *Analysis*. Taking into account all of the facts and circumstances, Corp A is treated as providing services to Corp H. Under paragraph (d) of this section, Corp A is treated as providing services to Corp H because Corp H bears all of the risks of loss associated with the development of Program Q and is the owner of all copyright rights in Program Q. Under paragraph (g)(1) of this section, the fact that the agreement is labelled a license is not controlling (nor is the fact that Corp A receives a sum labelled a royalty).

Example 16. (i) *Facts*. Corp A, a U.S. corporation, and Corp I, a Country Z corporation, agree that a development engineer employed by Corp A will travel to Country Z to provide know-how relating to certain techniques not generally known to computer programmers, which will enable Corp I to more efficiently create computer programs. These techniques represent the product of experience gained by Corp A from working on many computer programming projects, and are furnished to Corp I under nondisclosure conditions. Such information is property subject to trade secret protection.

(ii) *Analysis*. This transaction contains the elements of know-how specified in paragraph (e) of this section. Therefore, this transaction will be treated as the provision of know-how.

Example 17. (i) *Facts*. Corp A, a U.S. corporation, transfers a disk containing Program Y to Corp E, a Country Z corporation, in exchange for a single fixed payment. Program Y is a computer program development program, which is used to create other computer programs, consisting of several components, including libraries of reusable software components that serve as general building blocks in new software applications. No element of these libraries is a significant component of any overall new program. Because a computer program created with the use of Program Y will not operate unless the libraries are also present, the license agreement between Corp A and Corp E grants Corp E the right to distribute copies of the libraries with any program developed using Program Y. The license agreement is otherwise identical to the license agreement in *Example 1*.

(ii) *Analysis*. (A) No non-de minimis copyright rights described in paragraph (c)(2) of this section have passed to Corp E. For purposes of paragraph (b)(2) of this section, the right to distribute the libraries in conjunction with the programs created using Program Y is a de minimis component of the transaction. Because Corp E has received a copy of the program under paragraph (c)(1)(ii) of this section, it has received a copyrighted article.

(B) Taking into account all the facts and circumstances, Corp E is properly treated as the owner of a copyrighted article. Therefore, under paragraph (f)(2) of this section, there has been the sale of a copyrighted article rather than the grant of a lease.

Example 18. (i) *Facts*. (A) Corp A, a U.S. corporation, transfers a disk containing Program X to Corp E, a country Z Corporation. The disk contains both the object code and the source code to Program X and the license agreement grants Corp E the right to—

(*1*) Modify the source code in order to correct minor errors and make minor adaptations to Program X so it will function on Corp E's computer; and

(*2*) Recompile the modified source code.

(B) The license does not grant Corp E the right to distribute the modified Program X to the public. The license is otherwise identical to the license agreement in *Example 1*.

(ii) *Analysis*. (A) No non-de minimis copyright rights described in paragraph (c)(2) of this section have passed to Corp E. For purposes of paragraph (b)(2) of this section, the right to modify the source code and recompile the source code in order to create new code to correct minor errors and make minor adaptations is a de minimis component of the transaction. Because Corp E has received a copy of the program under paragraph (c)(1)(ii) of this section, it has received a copyrighted article.

(B) Taking into account all the facts and circumstances, Corp E is properly treated as the owner of a copyrighted article. Therefore, under paragraph (f)(2) of this section, there has been the sale of a copyrighted article rather than the grant of a lease.

(i) *Effective date*—(1) *General*. This section applies to transactions occurring pursuant to contracts entered into on or after December 1, 1998.

(2) *Elective transition rules*—(i) *Contracts entered into in taxable years ending on or after October 2, 1998*. A taxpayer may elect to apply this section to transactions occurring pursuant to contracts entered into in taxable years ending on or after October 2, 1998. A taxpayer that makes an election under this paragraph (i)(2)(i) must apply this section to all contracts entered into in

taxable years ending on or after October 2, 1998.

(ii) *Contracts entered into before October 2, 1998.* A taxpayer may elect to apply this section to transactions occurring in taxable years ending on or after October 2, 1998 pursuant to contracts entered into before October 2, 1998 provided the taxpayer would not be required under this section to change its method of accounting as a result of such election, or the taxpayer would be required to change its method of accounting but the resulting section 481(a) adjustment would be zero. A taxpayer that makes an election under this paragraph (i)(2)(ii) must apply this section to all transactions occurring in taxable years ending on or after October 2, 1998 pursuant to contracts entered into before October 2, 1998.

(3) *Manner of making election.* Taxpayers may elect, under paragraph (i)(2)(i) or (i)(2)(ii) of this section, to apply this section, by treating the transactions in accordance with these regulations on their original tax return.

(4) *Examples.* The following examples illustrate application of the transition rule of paragraph (i)(2)(ii) of this section:

Example 1. Corp A develops computer programs for sale to third parties. Corp A uses an overall accrual method of accounting and files its tax return on a calendar-year basis. In year 1, Corp A enters into a contract to deliver a computer program in that year, and to provide updates for each of the following four years. Under the contract, the computer program and the updates are priced separately, and Corp A is entitled to receive payments for the computer program and each of the updates upon delivery. Assume Corp A properly accounts for the contract as a contract for the provision of services. Corp A properly includes the payments under the contract in gross income in the taxable year the payments are received and the computer program or updates are delivered. Corp A properly deducts the cost of developing the computer program and updates when the costs are incurred. Year 3 includes ctober 2, 1998. Assume under the rules of this section, the provision of updates would properly be accounted for as the transfer of copyrighted articles. If Corp A made an election under paragraph (i)(2)(ii) of this section, Corp A would not be required to change its method of accounting for income under the contract as a result of the election. Corp A would also not be required to change its method of accounting for the cost of developing the computer program and the updates under the contract as a result of the election. Therefore, under paragraph (i)(2)(ii) of this section, Corp A may elect to apply the provisions of this section to the updates provided in years 3, 4, and 5, because Corp A is not required to change from its method of accounting for the contract as a result of the election.

Example 2. Corp A develops computer programs for sale to third parties. Corp A uses an overall accrual method of accounting and files its tax return on a calendar-year basis. In year 1, Corp A enters into a contract to deliver a computer program and to provide one update the following year. Under the contract, the computer program and the update are priced separately, and Corp A is entitled to receive payment for the computer program and the update upon delivery of the computer program. Assume Corp A properly accounts for the contract as a contract for the provision of services. Corp A properly includes the portion of the payment relating to the computer program in gross income in year 1, the taxable year the payment is received and the program delivered. Corp A properly includes the portion of the payment relating to the update in gross income in year 2, the taxable year the update is provided, under Rev. Proc. 71–21, 1971–2 CB 549 (see § 601.601 (d)(2) of this chapter). Corp A properly deducts the cost of developing the computer program and update when the costs are incurred. Year 2 includes October 2, 1998. Assume under the rules of this section, provision of the update would properly be accounted for as the transfer of a copyrighted article. If Corp A made an election under paragraph (i)(2)(ii) of this section, Corp A would be required to change its method of accounting for deferring income under its contract as a result of the election. However, the section 481(a) adjustment would be zero because the portion of the payment relating to the update would be includible in gross income in year 2, the taxable year the update is provided, under both Rev. Proc. 71–21 and § 1.451–5. Corp A would not be required to change its method of accounting for the cost of developing the computer program and the update under the contract as a result of the election. Therefore, under paragraph (i)(2)(ii) of this section, Corp A may elect to apply the provisions of this section to the update in year 2, because the section 481(a) adjustment resulting from the change in method of accounting for deferring advance payments under the contract is zero, and because Corp A is not required to change from its method of accounting for the cost of developing the computer program and updates under the contract as a result of the election.

Example 3. Assume the same facts as in *Example 1* except that Corp A is entitled to receive payments for the computer program

and each of the updates 30 days after delivery. Corp A properly includes the amounts due under the contract in gross income in the taxable year the computer program or updates are provided. Assume that Corp A properly uses the nonaccrual-experience method described in section 448(d)(5) and § 1.448–2T to account for income on its contracts. If Corp A made an election under paragraph (i)(2)(ii) of this section, Corp A would be required to change from the nonaccrual-experience method for income as a result of the election, because the method is only available with respect to amounts to be received for the performance of services. Therefore, Corp A may not elect to apply the provisions of this section to the updates provided in years 3, 4, and 5, under paragraph (i)(2)(ii) of this section, because Corp A would be required to change from the nonaccrual-experience method of accounting for income on the contract as a result of the election.

(j) *Change in method of accounting required by this section*—(1) *Consent.* A taxpayer is granted consent to change its method of accounting for contracts involving computer programs, to conform with the classification prescribed in this section. The consent is granted for contracts entered into on or after December 1, 1998, or in the case of a taxpayer making an election under paragraph (i)(2)(i) of this section, the consent is granted for contracts entered into in taxable years ending on or after October 2, 1998. In addition, a taxpayer that makes an election under paragraph (i)(2)(ii) of this section is granted consent to change its method of accounting for any contract with transactions subject to the election, if the taxpayer is required to change its method of accounting as a result of the election.

(2) *Year of change.* The year of change is the taxable year that includes December 1, 1998, or in the case of a taxpayer making an election under paragraph (i)(2)(i) or (i)(2)(ii) of this section, the taxable year that includes October 2, 1998.

(k) *Time and manner of making change in method of accounting*—(1) *General.* A taxpayer changing its method of accounting in accordance with this section must file a Form 3115, Application for Change in Method of Accounting, in duplicate. The taxpayer must type or print the following statement at the top of page 1 of the Form 3115: ''FILED UNDER TREASURY REGULATION § 1.861–18.'' The original Form 3115 must be attached to the taxpayers original return for the year of change. A copy of the Form 3115 must be filed with the National Office no later than when the original Form 3115 is filed for the year of change.

(2) *Copy of Form 3115.* The copy required by this paragraph (k)(1) to be sent to the national office should be sent to the Commissioner of Internal Revenue, Attention: CC:DOM:IT&A, P.O. Box 7604, Benjamin Franklin Station, Washington DC 20044 (or in the case of a designated private delivery service: Commissioner of Internal Revenue, Attention: CC:DOM:IT&A, 1111 Constitution Avenue, NW., Washington, DC 20224).

(3) *Effect of consent and Internal Revenue Service review.* A change in method of accounting granted under this section is subject to review by the district director and the national office and may be modified or revoked in accordance with the provisions of Rev. Proc. 97–37 (1997–33 IRB 18) (or its successors) (see § 601.601(d)(2) of this chapter).

[T.D. 8785, 63 FR 52977, Oct. 2, 1998; 63 FR 64868, Nov. 24, 1998]

§ 1.862–1 Income specifically from sources without the United States.

(a) *Gross income.* (1) The following items of gross income shall be treated as income from sources without the United States:

(i) Interest other than that specified in section 861(a)(1) and § 1.861–2 as being derived from sources within the United States;

(ii) Dividends other than those derived from sources within the United States as provided in section 861(a)(2) and § 1.861–3;

(iii) Compensation for labor or personal services performed without the United States;

(iv) Rentals or royalties from property located without the United States or from any interest in such property, including rentals or royalties for the use of, or for the privilege of using, without the United States, patents, copyrights, secret processes and formulas, goodwill, trademarks, trade brands, franchises, and other like property;

(v) Gains, profits, and income from the sale of real property located without the United States; and

(vi) Gains, profits, and income derived from the purchase of personal property within the United States and its sale without the United States.

(2) In applying subparagraph (1)(iv) of this paragraph for taxable years beginning after December 31, 1966, gains described in section 871(a)(1)(D) and section 881(a)(4) from the sale or exchange after October 4, 1966, of patents, copyrights, and other like property shall be treated, as provided in section 871(e)(2), as rentals or royalties for the use of, or privilege of using, property or an interest in property. See paragraph (e) of § 1.871–11.

(3) For determining the time and place of sale of personal property for purposes of subparagraph (1)(vi) of this paragraph, see paragraph (c) of § 1.861–7.

(4) Income derived from the purchase of personal property within the United States and its sale within a possession of the United States shall be treated as derived entirely from within that possession.

(5) If interest is paid on an obligation of a nonresident of the United States by a resident of the United States acting in the resident's capacity as a guarantor of the obligation of the nonresident, the interest will be treated as income from sources without the United States.

(6) For rules treating certain interest as income from sources without the United States, see paragraph (b) of § 1.861–2.

(7) For the treatment of compensation for labor or personal services performed partly within the United States and partly without the United States, see paragraph (b) of § 1.861–4.

(b) *Taxable income.* The taxable income from sources without the United States, in the case of the items of gross income specified in paragraph (a) of this section, shall be determined on the same basis as that used in § 1.861–8 for determining the taxable income from sources within the United States.

(c) *Income from certain property.* For provisions permitting a taxpayer to elect to treat amounts of gross income attributable to certain aircraft or vessels first leased on or before December 28, 1980, as income from sources within the United States which would otherwise be treated as income from sources without the United States under paragraph (a) of this section, see § 1.861–9. For provisions requiring amounts of gross income attributable to certain aircraft, vessels, or spacecraft first leased by the taxpayer after December 28, 1980, to be treated as income from sources within the United States which would otherwise be treated as income from sources without the United States under paragraph (a) of this section, see § 1.861–9A.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 7378, 40 FR 45434, Oct. 2, 1975; 40 FR 48508, Oct. 16, 1975; T.D. 7928, 48 FR 55847, Dec. 16, 1983]

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[T.D. 8687, 61 FR 60545, Nov. 29, 1996, as amended by T.D. 9128, 69 FR 26040, May 11, 2004; T.D. 9272, 71 FR 43366, Aug. 1, 2006]

§ 1.863–1 Allocation of gross income under section 863(a).

(a) *In general.* Items of gross income other than those specified in section 861(a) and section 862(a) will generally be separately allocated to sources within or without the United States. See § 1.863–2 for alternate methods to determine the income from sources within or without the United States in the case of items specified in § 1.863–2(a). See also sections 865(b) and (e)(2). In the case of sales of property involving partners and partnerships, the rules of § 1.863–3(g) apply.

(b) *Natural resources*—(1) *In general.* Notwithstanding any other provision, except to the extent provided in paragraph (b)(2) of this section, gross receipts from the sale outside the United States of products derived from the ownership or operation of any farm, mine, oil or gas well, other natural deposit, or timber within the United States, must be allocated between sources within and without the United States based on the fair market value of the product at the export terminal (as defined in paragraph (b)(3)(iii) of this section). Notwithstanding any other provision, except to the extent provided in paragraph (b)(2) of this section, gross receipts from the sale within the United States of products derived from the ownership or operation of any farm, mine, oil or gas well, other natural deposit, or timber outside the United States must be allocated between sources within and without the United States based on the fair market value of the product at the export terminal. For place of sale, see §§ 1.861–7(c) and 1.863–3(c)(2). The source of gross receipts equal to the fair market value of the product at the export terminal will be from sources where the farm, mine, well, deposit, or uncut timber is located. The source of gross receipts from the sale of the product in excess of its fair market value at the export terminal (excess gross receipts) will be determined as follows—

(i) If the taxpayer engages in additional production activities subsequent to shipment from the export terminal and outside the country of sale, the source of excess gross receipts must be determined under § 1.863–3. For purposes of applying § 1.863–3, only production assets used in additional production activity subsequent to the export terminal are taken into account.

(ii) In all other cases, excess gross receipts will be from sources within the country of sale. This paragraph (b)(1)(ii) applies to a taxpayer that engages in additional production activities in the country of sale, as well as to a taxpayer that does not engage in additional production activities at all.

(2) *Additional production prior to export terminal.* Notwithstanding any other provision of this section, gross receipts from the sale of products derived by a taxpayer who performs additional production activities as defined in paragraph (b)(3)(ii) of this section before the relevant product is shipped from the export terminal are allocated between sources within and without the United States based on the fair

market value of the product immediately prior to the additional production activities. The source of gross receipts equal to the fair market value of the product immediately prior to the additional production activities will be from sources where the farm, mine, well, deposit, or uncut timber is located. The source of gross receipts from the sale of the product in excess of the fair market value immediately prior to the additional production activities must be determined under §1.863–3. For purposes of applying §1.863–3, only production assets used in the additional production activities are taken into account.

(3) *Definitions*—(i) *Production activity*. For purposes of this section, production activity means an activity that creates, fabricates, manufactures, extracts, processes, cures, or ages inventory. See §1.864–1. Except as otherwise provided in §§1.1502–13 or 1.863–3(g)(2), only production activities conducted directly by the taxpayer are taken into account.

(ii) *Additional production activities*. For purposes of this section, additional production activities are substantial production activities performed directly by the taxpayer in addition to activities from the ownership or operation of any farm, mine, oil or gas well, other natural deposit, or timber. Whether a taxpayer's activities constitute additional production activities will be determined under the principles of §1.954–3(a)(4). However, in no case will activities that prepare the natural resource itself for export, including those that are designed to facilitate the transportation of the natural resource to or from the export terminal, be considered additional production activities for purposes of this section.

(iii) *Export terminal*. Where the farm, mine, well, deposit, or uncut timber is located without the United States, the export terminal will be the final point in a foreign country from which goods are shipped to the United States. If there is no such final point in a foreign country (e.g., the property is extracted and produced on the high seas), the export terminal will be the place of production. Where the farm, mine, well, deposit, or uncut timber is located within the United States, the export terminal will be the final point in the United States from which goods are shipped from the United States to a foreign country. The location of the export terminal is determined without regard to any contractual terms agreed to by the taxpayer and without regard to whether there is an actual sale of the products at the export terminal.

(4) *Determination of fair market value*. For purposes of this section, fair market value depends on all of the facts and circumstances as they exist relative to a party in any particular case. Where the products are sold to a related party in a transaction subject to section 482, the determination of fair market value under this section must be consistent with the arm's length price determined under section 482.

(5) *Determination of gross income*. To determine the amount of a taxpayer's gross income from sources within or without the United States, the taxpayer's gross receipts from sources within or without the United States determined under this paragraph (b) must be reduced by the cost of goods sold properly attributable to gross receipts from sources within or without the United States.

(6) *Tax return disclosure*. A taxpayer that determines the source of its income under this paragraph (b) shall attach a statement to its return explaining the methodology used to determine fair market value under paragraph (b)(4) of this section, and explaining any additional production activities (as defined in paragraph (b)(3)(ii) of this section) performed by the taxpayer. In addition, the taxpayer must provide such other information as is required by §1.863–3.

(7) *Examples*. The following examples illustrate the rules of this paragraph (b):

Example 1. No additional production. U.S. Mines, a U.S. corporation, operates a copper mine and mill in country X. U.S. Mines extracts copper-bearing rocks from the ground and transports the rocks to the mill where the rocks are ground and processed to produce copper-bearing concentrate. The concentrate is transported to a port where it is dried in preparation for export, stored and then shipped to purchasers in the United States. Because title to the property is passed in the United States and, under the facts and circumstances, none of U.S. Mine's

activities constitutes additional production prior to the export terminal within the meaning of paragraph (b)(3)(ii) of this section, under paragraph (b)(1) and (b)(1)(ii) of this section, gross receipts equal to the fair market value of the concentrate at the export terminal will be from sources without the United States, and excess gross receipts will be from sources within the United States.

Example 2. No additional production. US Gas, a U.S. corporation, extracts natural gas within the United States, and transports the natural gas to a U.S. port where it is liquified in preparation for shipment. The liquified natural gas is then transported via freighter and sold without additional production activities in a foreign country. Liquefaction of natural gas is not an additional production activity because liquefaction prepares the natural gas for transportation from the export terminal. Therefore, under paragraph (b)(1) and (b)(1)(ii) of this section, gross receipts equal to the fair market value of the liquefied natural gas at the export terminal will be from sources within the United States, and excess gross receipts will be from sources without the United States.

Example 3. Sale in third country. US Gold, a U.S. corporation, mines gold in country X, produces gold jewelry in the United States, and sells the jewelry in country Y. Assume that the fair market value of the gold at the export terminal in country X is $40, and that US Gold ultimately sells the gold jewelry in country Y for $100. Under §1.863–1(b), $40 of US Gold's gross receipts will be allocated to sources without the United States. Under paragraph (b)(1)(i) of this section, the source of the remaining $60 of gross receipts will be determined under §1.863–3. If US Gold applies the 50/50 method described in §1.863–3, $20 of cost of goods sold is properly attributable to activities subsequent to the export terminal, and all of US Gold's production assets subsequent to the export terminal are located in the United States, then $20 of gross income will be allocated to sources within the United States and $20 of gross income will be allocated to sources without the United States.

Example 4. Production in country of sale. US Oil, a U.S. corporation, extracts oil in country X, transports the oil via pipeline to the export terminal in country Y, refines the oil in the United States, and sells the refined product in the United States to unrelated persons. Assume that the fair market value of the oil at the export terminal in country Y is $80, and that US Oil ultimately sells the refined product for $100. Under paragraph (b)(1) of this section, $80 of US Oil's gross receipts will be allocated to sources without the United States, and under paragraph (b)(1)(ii) of this section the remaining $20 of gross receipts will be allocated to sources within the United States.

Example 5. Additional production prior to export. The facts are the same as in *Example 1*, except that U.S. Mines also operates a smelter in country X. The concentrate output from the mill is transported to the smelter where it is transformed into smelted copper. The smelted copper is exported to purchasers in the United States. Under the facts and circumstances, all of the processes applied to make copper concentrate are considered mining. Therefore, under paragraph (b)(2) of this section, gross receipts equal to the fair market value of the concentrate at the smelter will be from sources without the United States. Under the facts and circumstances, the conversion of the concentrate into smelted copper is an additional production activity in a foreign country within the meaning of paragraph (b)(3)(ii) of this section. Therefore, the source of U.S. Mine's excess gross receipts will be determined pursuant to paragraph (b)(2) of this section.

(c) *Determination of taxable income.* The taxpayer's taxable income from sources within or without the United States will be determined under the rules of §§1.861–8 through 1.861–14T for determining taxable income from sources within the United States.

(d) *Scholarships, fellowship grants, grants, prizes and awards*—(1) *In general.* This paragraph (d) applies to scholarships, fellowship grants, grants, prizes and awards. The provisions of this paragraph (d) do not apply to amounts paid as salary or other compensation for services.

(2) *Source of income.* The source of income from scholarships, fellowship grants, grants, prizes and awards is determined as follows:

(i) *United States source income.* Except as provided in paragraph (d)(2)(iii) of this section, scholarships, fellowship grants, grants, prizes and awards made by a U.S. citizen or resident, a domestic partnership, a domestic corporation, an estate or trust (other than a foreign estate or trust within the meaning of section 7701(a)(31)), the United States (or an instrumentality or agency thereof), a State (or any political subdivision thereof), or the District of Columbia shall be treated as income from sources within the United States.

(ii) *Foreign source income.* Scholarships, fellowship grants, grants, prizes and awards made by a foreign government (or an instrumentality, agency,

or any political subdivision thereof), an international organization (as defined in section 7701(a)(18)), or a person other than a U.S. person (as defined in section 7701(a)(30)) shall be treated as income from sources without the United States.

(iii) *Certain activities conducted outside the United States.* Scholarships, fellowship grants, targeted grants, and achievement awards received by a person other than a U.S. person (as defined in section 7701(a)(30)) with respect to activities previously conducted (in the case of achievement awards) or to be conducted (in the case of scholarships, fellowships grants, and targeted grants) outside the United States shall be treated as income from sources without the United States.

(3) *Definitions.* The following definitions apply for purposes of this paragraph (d):

(i) *Scholarships* are defined in section 117 and the regulations thereunder.

(ii) *Fellowship grants* are defined in section 117 and the regulations thereunder.

(iii) *Prizes and awards* are defined in section 74 and the regulations thereunder.

(iv) *Grants* are amounts described in subparagraph (3) of section 4945(g) and the regulations thereunder, and are not amounts otherwise described in paragraphs (d)(3) (i), (ii), or (iii) of this section. For purposes of this paragraph (d), the reference to section 4945(g)(3) is applied without regard to the identity of the payor or recipient and without the application of the objective and nondiscriminatory basis test and the requirement of a procedure approved in advance.

(v) *Targeted grants* are grants—

(A) Issued by an organization described in section 501(c)(3), the United States (or an instrumentality or agency thereof), a State (or any political subdivision thereof), or the District of Columbia; and

(B) For an activity undertaken in the public interest and not primarily for the private financial benefit of a specific person or persons or organization.

(vi) *Achievement awards* are awards—

(A) Issued by an organization described in section 501(c)(3), the United States (or an instrumentality or agency thereof), a State (or political subdivision thereof), or the District of Columbia; and

(B) For a past activity undertaken in the public interest and not primarily for the private financial benefit of a specific person or persons or organization.

(4) *Effective dates.* The following are the effective dates concerning this paragraph (d):

(i) *Scholarships and fellowship grants.* This paragraph (d) is effective for scholarship and fellowship grant payments made after December 31, 1986. However, for scholarship and fellowship grant payments made after May 14, 1989, and before June 16, 1993, the residence of the payor rule of paragraph (d)(2) (i) and (ii) of this section may be applied without applying paragraph (d)(2)(iii) of this section.

(ii) *Grants, prizes and awards.* This paragraph (d) is effective for payments made for grants, prizes and awards, targeted grants, and achievement awards after September 25, 1995. However, the taxpayer may elect to apply the provisions of this paragraph (d) to payments made for grants, prizes and awards, targeted grants, and achievement awards after December 31, 1986, and before September 26, 1995.

(e) *Residual interest in a REMIC*—(1) *REMIC inducement fees.* An inducement fee (as defined in §1.446–6(b)(2)) shall be treated as income from sources within the United States.

(2) *Excess inclusion income and net losses.* An excess inclusion (as defined in section 860E(c)) shall be treated as income from sources within the United States. To the extent of excess inclusion income previously taken into account with respect to a residual interest (reduced by net losses previously taken into account under this paragraph), a net loss (described in section 860C(b)(2)) with respect to the residual interest shall be allocated to the class of gross income and apportioned to the statutory grouping(s) or residual grouping of gross income to which the excess inclusion income was assigned.

(f) *Effective/applicability date.* Paragraph (e)(2) of this section applies for

taxable years ending after August 1, 2006.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 8615, 60 FR 44275, Aug. 25, 1995; T.D. 8687, 61 FR 60545, Nov. 29, 1996; 61 FR 65323, Dec. 12, 1996; T.D. 9128, 69 FR 26041, May 11, 2004; T.D. 9272, 71 FR 43366, Aug. 1, 2006; T.D. 9415, 73 FR 40172, July 14, 2008]

§ 1.863–2 Allocation and apportionment of taxable income.

(a) *Determination of taxable income.* Section 863(b) provides an alternate method for determining taxable income from sources within the United States in the case of gross income derived from sources partly within and partly without the United States. Under this method, taxable income is determined by deducting from such gross income the expenses, losses, or other deductions properly apportioned or allocated thereto and a ratable part of any other expenses, losses, or deductions that cannot definitely be allocated to some item or class of gross income. The income to which this section applies (and that is treated as derived partly from sources within and partly from sources without the United States) will consist of gains, profits, and income

(1) From certain transportation or other services rendered partly within and partly without the United States to the extent not within the scope of section 863(c) or other specific provisions of this title;

(2) From the sale of inventory property (within the meaning of section 865(i)) produced (in whole or in part) by the taxpayer in the United States and sold outside the United States or produced (in whole or in part) by the taxpayer outside the United States and sold in the United States; or

(3) Derived from the purchase of personal property within a possession of the United States and its sale within the United States, to the extent not excluded from the scope of these regulations under § 1.936–6(a)(5),

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(b) *Determination of source of taxable income.* Income treated as derived from sources partly within and partly without the United States under paragraph (a) of this section may be allocated to sources within and without the United States pursuant to § 1.863–1 or apportioned to such sources in accordance with the methods described in other regulations under section 863. To determine the source of certain types of income described in paragraph (a)(1) of this section, see § 1.863–4. To determine the source of gross income described in paragraph (a)(2) of this section, see § 1.863–1 for natural resources and see § 1.863–3 for other inventory. Taxpayers, at their election, may apply the principles of § 1.863–3 (b)(1) and (c) to determine the source of taxable income (rather than gross income) from sales of inventory property (other than natural resources). To determine the source of income partly from sources within a possession of the United States, including income described in paragraph (a)(3) of this section, see § 1.863–3(f).

(c) *Effective dates.* This section will apply to taxable years beginning after December 30, 1996. However, taxpayers may apply the rules of this section for taxable years beginning after July 11, 1995, and on or before December 30, 1996. For years beginning before December 30, 1996, see § 1.863–2 (as contained in 26 CFR part 1 revised as of April 1, 1996).

[T.D. 8687, 61 FR 60546, Nov. 29, 1996; 61 FR 65323, Dec. 12, 1996]

§ 1.863–3 Allocation and apportionment of income from certain sales of inventory.

(a) *In general*—(1) *Scope.* Paragraphs (a) through (e) of this section apply to determine the source of income derived from the sale of inventory property (inventory), which a taxpayer produces (in whole or in part) within the United States and sells outside the United States, or which a taxpayer produces (in whole or in part) outside the United States and sells within the United States (Section 863 Sales). To determine the source of income from sales of property produced by the taxpayer, when the property is either produced in whole or in part in space or on or under water not within the jurisdiction (as recognized by the United States) of a foreign country, possession of the United States, or the United States (in international water), or is sold in space or international water, the rules of

§ 1.863–8 apply, and the rules of this section do not apply except to the extent provided in § 1.863–8. A taxpayer must divide gross income from Section 863 Sales between production activity and sales activity using one of the methods described in paragraph (b) of this section. The source of gross income from production activity and from sales activity must then be determined under paragraph (c) of this section. Taxable income from Section 863 Sales is determined under paragraph (d) of this section. Paragraph (e) of this section describes the rules for electing the methods described in paragraph (b) of this section and the information that a taxpayer must disclose on a tax return. Paragraph (f) of this section applies to determine the source of certain income derived from a possession of the United States. Paragraph (g) of this section provides special rules for partnerships for all sales subject to §§ 1.863–1 through 1.863–3. Paragraph (h) of this section provides effective dates for the rules in this section.

(2) *Rules of application for Section 863 Sales.* Once a taxpayer has elected a method described in paragraph (b) of this section, the taxpayer must separately apply that method to Section 863 Sales in the United States and to Section 863 Sales outside the United States. In addition, the taxpayer must apply the rules of paragraphs (c) and (d) of this section by aggregating all Section 863 Sales to which a method described in paragraph (b) of this section applies, after separately applying that method to Section 863 Sales in the United States and to Section 863 Sales outside the United States. See section 865(i)(1) for the definition of inventory property. See also section 865(e)(2). See § 1.861–7(c) and paragraph (c)(2) of this section for the time and place of sale.

(b) *Methods to determine income attributable to production activity and sales activity*—(1) *50/50 method*—(i) *Determination of gross income.* Generally, gross income from Section 863 Sales will be apportioned between production activity and sales activity under the 50/50 method as described in this paragraph (b)(1). Under the 50/50 method, one-half of the taxpayer's gross income will be considered income attributable to production activity and the source of that income will be determined under the rules of paragraph (c)(1) of this section. The remaining one-half of such gross income will be considered income attributable to sales activity and the source of that income will be determined under the rules of paragraph (c)(2) of this section. In lieu of the 50/50 method, the taxpayer may elect to determine the source of income from Section 863 Sales under the IFP method described in paragraph (b)(2) of this section or, with the consent of the District Director, the books and records method described in paragraph (b)(3) of this section.

(ii) *Example.* The following example illustrates the rules of this paragraph (b)(1):

Example. 50/50 method. (i) P, a U.S. corporation, produces widgets in the United States. P sells the widgets for $100 to D, an unrelated foreign distributor, in another country. P's cost of goods sold is $40. Thus, P's gross income is $60.

(ii) Pursuant to the 50/50 method, one-half of P's gross income, or $30, is considered income attributable to production activity, and one-half of P's gross income, or $30, is considered income attributable to sales activity.

(2) *IFP method*—(i) *Establishing an IFP.* A taxpayer may elect to allocate gross income earned from production activity and sales activity using the independent factory price (IFP) method described in this paragraph (b)(2) if an IFP is fairly established. An IFP is fairly established based on a sale by the taxpayer only if the taxpayer regularly sells part of its output to wholly independent distributors or other selling concerns in such a way as to reasonably reflect the income earned from production activity. A sale will not be considered to fairly establish an IFP if sales activity by the taxpayer with respect to that sale is significant in relation to all of the activities with respect to that product.

(ii) *Applying the IFP method.* If the taxpayer elects to use the IFP method, the amount of the gross sales price equal to the IFP will be treated as attributable to production activity, and the excess of the gross sales price over the IFP will be treated as attributable to sales activity. If a taxpayer elects to use the IFP method, the IFP must be

applied to all Section 863 Sales of inventory that are substantially similar in physical characteristics and function, and are sold at a similar level of distribution as the inventory sold in the sale fairly establishing an IFP. The IFP will only be applied to sales that are reasonably contemporaneous with the sale fairly establishing the IFP. An IFP cannot be applied to sales in other geographic markets if the markets are substantially different. If the taxpayer elects the IFP method, the rules of this paragraph will also apply to determine the division of gross receipts between production activity and sales activity in a Section 863 Sale that itself fairly establishes an IFP. If the taxpayer elects to apply the IFP method, the IFP method must be applied to all sales for which an IFP may be fairly established and applied for that taxable year and each subsequent taxable year. The taxpayer will apply either the 50/50 method described in paragraph (b)(1) of this section or the books and records method described in paragraph (b)(3) of this section to any other Section 863 Sale for which an IFP cannot be established or applied for each taxable year.

(iii) *Determination of gross income*. The amount of a taxpayer's gross income from production activity is determined by reducing the amount of gross receipts from production activity by the cost of goods sold properly attributable to production activity. The amount of a taxpayer's gross income from sales activity is determined by reducing the amount of gross receipts from sales activity by the cost of goods sold (if any) properly attributable to sales activity. The source of gross income from production activity is determined under the rules of paragraph (c)(1) of this section, and the source of gross income from sales activity will be determined under the rules of paragraph (c)(2) of this section.

(iv) *Examples*. The following examples illustrate the rules of this paragraph (b)(2):

Example 1. IFP method. (i) P, a U.S. producer, purchases cotton and produces cloth in the United States. P sells cloth in country X to D, an unrelated foreign clothing manufacturer, for $100. Cost of goods sold for cloth is $80, entirely attributable to production activity. P does not engage in significant sales activity in relation to its other activities in the sales to D. Under these facts, the sale to D fairly establishes an IFP of $100. Assume that P elects to use the IFP method. Accordingly, $100 of the gross sales price is treated as attributable to production activity, and no amount of income from this sale is attributable to sales activity. After reducing the gross sales price by cost of goods sold, $20 of the gross income is treated as attributable to production activity ($100–$80).

(ii) P also sells cloth in country X to A, an unrelated foreign retail outlet, for $110. Because P elected the IFP method and the cloth is substantially similar to the cloth sold to D, the IFP fairly established in the sales to D must be used to determine the amount attributable to production activity in the sale to A. Accordingly, $100 of the gross sales price is treated as attributable to production activity and $10 ($110–$100) is attributable to sales activity. After reducing the gross sales price by cost of goods sold, $20 of the gross income is treated as attributable to production activity ($100–$80) and $10 is attributable to sales activity.

Example 2. Scope of IFP Method. (i) USCo manufactures three dissimilar products. USCo elects to apply the IFP method. In year 1, an IFP can be established for sales of product X, but not for products Y and Z. In year 2, an IFP cannot be established for any of USCo's products. In year 3, an IFP can be established for products X and Y, but not for product Z.

(ii) In year 1, USCo must apply the IFP method to sales of product X. In year 2, although USCo's IFP election remains in effect, USCo is not required to apply the IFP election to any products. In year 3, USCo is required to apply the IFP method to sales of products X and Y.

(3) *Books and records method*. A taxpayer may elect to determine the amount of its gross income from Section 863 Sales that is attributable to production and sales activities for the taxable year based upon its books of account if it has received in advance the permission of the District Director having audit responsibility over its tax return. The taxpayer must establish to the satisfaction of the District Director that the taxpayer, in good faith and unaffected by considerations of tax liability, will regularly employ in its books of account a detailed allocation of receipts and expenditures which clearly reflects the amount of the taxpayer's income from production and sales activities. If a taxpayer receives permission to apply the books and records method, but does not comply with a material condition set forth by

the District Director, the District Director may, in its discretion, revoke permission to use the books and records method. The source of gross income treated as attributable to production activity under this method may be determined under the rules of paragraph (c)(1) of this section, and the source of gross income attributable to sales activity will be determined under the rules of paragraph (c)(2) of this section.

(c) *Determination of the source of gross income from production activity and sales activity*—(1) *Income attributable to production activity*—(i) *Production only within the United States or only within foreign countries*—(A) *Source of income.* For purposes of this section, production activity means an activity that creates, fabricates, manufactures, extracts, processes, cures, or ages inventory. See §1.864–1. Subject to the provisions in §1.1502–13 or paragraph (g)(2)(ii) of this section, the only production activities that are taken into account for purposes of §§1.863–1, 1.863–2, and this section are those conducted directly by the taxpayer. Where the taxpayer's production assets are located only within the United States or only outside the United States, the income attributable to production activity is sourced where the taxpayer's production assets are located. For rules regarding the source of income when production assets are located both within the United States and without the United States, see paragraph (c)(1)(ii) of this section. For rules regarding the source of income when production takes place, in whole or in part, in space or international water, the rules of §1.863–8 apply, and the rules of this section do not apply except to the extent provided in §1.863–8.

(B) *Definition of production assets.* Subject to the provisions of §1.1502–13 and paragraph (g)(2)(ii) of this section, production assets include only tangible and intangible assets owned directly by the taxpayer that are directly used by the taxpayer to produce inventory described in paragraph (a) of this section. Production assets do not include assets that are not directly used to produce inventory described in paragraph (a) of this section. Thus, production assets do not include such assets as accounts receivables, intangibles not related to production of inventory (e.g., marketing intangibles, including trademarks and customer lists), transportation assets, warehouses, the inventory itself, raw materials, or work-in-process. In addition, production assets do not include cash or other liquid assets (including working capital), investment assets, prepaid expenses, or stock of a subsidiary.

(C) *Location of production assets.* For purposes of this section, a tangible production asset will be considered located where the asset is physically located. An intangible production asset will be considered located where the tangible production assets owned by the taxpayer to which it relates are located.

(ii) *Production both within the United States and within foreign countries*—(A) *Source of income.* Where the taxpayer's production assets are located both within and without the United States, income from sources without the United States will be determined by multiplying the income attributable to the taxpayer's production activity by a fraction, the numerator of which is the average adjusted basis of production assets that are located outside the United States and the denominator of which is the average adjusted basis of all production assets within and without the United States. The remaining income is treated as from sources within the United States.

(B) *Adjusted basis of production assets.* For purposes of paragraph (c)(1)(ii)(A) of this section, the adjusted basis of an asset is determined under section 1011. The average adjusted basis is computed by averaging the adjusted basis of the asset at the beginning and end of the taxable year, unless by reason of material changes during the taxable year such average does not fairly represent the average for such year. In this event, the average adjusted basis will be determined upon a more appropriate basis. If production assets are used to produce inventory sold in Section 863 Sales and are also used to produce other property during the taxable year, the portion of its adjusted basis that is included in the fraction described in paragraph (c)(1)(ii)(A) of this section will be determined under any method

that reasonably reflects the portion of the assets that produces inventory sold in Section 863 Sales. For example, the portion of such an asset that is included in the formula may be determined by multiplying the asset's average adjusted basis by a fraction, the numerator of which is the gross receipts from sales of inventory from Section 863 Sales produced by the asset, and the denominator of which is the gross receipts from all property produced by that asset.

(iii) *Anti-abuse rule.* The purpose of this paragraph (c)(1) is to attribute the source of the taxpayer's production income to the location of the taxpayer's production activity. Therefore, if the taxpayer has entered into or structured one or more transactions with a principal purpose of reducing its U.S. tax liability by manipulating the formula described in paragraph (c)(1)(ii)(A) of this section in a manner inconsistent with the purpose of this paragraph (c)(1), the District Director may make appropriate adjustments so that the source of the taxpayer's income from production activity more clearly reflects the source of that income.

(iv) *Examples.* The following examples illustrate the rules of this paragraph (c)(1):

Example 1. Source of production income. (i) A, a U.S. corporation, produces widgets that are sold both within the United States and within a foreign country. The initial manufacture of all widgets occurs in the United States. The second stage of production of widgets that are sold within a foreign country is completed within the country of sale. A's U.S. plant and machinery which is involved in the initial manufacture of the widgets has an average adjusted basis of $200. A also owns warehouses used to store work-in-process. A owns foreign equipment with an average adjusted basis of $25. A's gross receipts from all sales of widgets is $100, and its gross receipts from export sales of widgets is $25. Assume that apportioning average adjusted basis using gross receipts is reasonable. Assume A's cost of goods sold from the sale of widgets in the foreign countries is $13 and thus, its gross income from widgets sold in foreign countries is $12. A uses the 50/50 method to divide its gross income between production activity and sales activity.

(ii) A determines its production gross income from sources without the United States by multiplying one-half of A's $12 of gross income from sales of widgets in foreign countries, or $6, by a fraction, the numerator of which is all relevant foreign production assets, or $25, and the denominator of which is all relevant production assets, or $75 ($25 foreign assets + ($200 U.S. assets × $25 gross receipts from export sales/$100 gross receipts from all sales)). Therefore, A's gross production income from sources without the United States is $2 ($6 × ($25/$75)).

Example 2. Location of intangible property. Assume the same facts as *Example 1*, except that A employs a patented process that applies only to the initial production of widgets. In computing the formula used to determine the source of income from production activity, A's patent, if it has an average adjusted basis, would be located in the United States.

Example 3. Anti-abuse rule. (i) Assume the same facts as *Example 1*. A sells its U.S. assets to B, an unrelated U.S. corporation, with a principal purpose of reducing its U.S. tax liability by manipulating the property fraction. A then leases these assets from B. After this transaction, under the general rule of paragraph (c)(1)(ii) of this section, all of A's production income would be considered from sources without the United States, because all of A's relevant production assets are located within a foreign country. Since the leased property is not owned by the taxpayer, it is not included in the fraction.

(ii) Because A has entered into a transaction with a principal purpose of reducing its U.S. tax liability by manipulating the formula described in paragraph (c)(1)(ii)(A) of this section, A's income must be adjusted to more clearly reflect the source of that income. In this case, the District Director may redetermine the source of A's production income by ignoring the sale-leaseback transactions.

(2) *Income attributable to sales activity.* The source of the taxpayer's income that is attributable to sales activity will be determined under the provisions of §1.861–7(c). Notwithstanding any other provision, for rules regarding the source of income when a sale takes place in space or international water, the rules of §1.863–8 apply, and the rules of this section do not apply except to the extent provided in §1.863–8. However, notwithstanding any other provision, for purposes of section 863, the place of sale will be presumed to be the United States if personal property is wholly produced in the United States and the property is sold for use, consumption, or disposition in the United States. See §1.864–6(b)(3)(ii) to determine the country of use, consumption, or disposition. Also, in applying this paragraph, property will be treated as

wholly produced in the United States if it is subject to no more than packaging, repackaging, labeling, or other minor assembly operations outside the United States, within the meaning of §1.954–3(a)(4)(iii) (property manufactured or produced by a controlled foreign corporation). Notwithstanding any other provision, for rules regarding the source of income when a sale takes place in space or international water, the rules of §1.863–8 apply, and the rules of this section do not apply except to the extent provided in §1.863–8.

(d) *Determination of source of taxable income.* Once the source of gross income has been determined under paragraph (c) of this section, the taxpayer must properly allocate and apportion separately under §§1.861–8 through 1.861–14T the amounts of its expenses, losses, and other deductions to its respective amounts of gross income from Section 863 Sales determined separately under each method described in paragraph (b) of this section. In addition, if the taxpayer deducts expenses for research and development under section 174 that may be attributed to its Section 863 Sales under §1.861–8(e)(3), the taxpayer must separately allocate or apportion expenses, losses, and other deductions to its respective amounts of gross income from each relevant product category that the taxpayer uses in applying the rules of §1.861–8(e)(3)(i)(A). In the case of gross income from Section 863 Sales determined under the IFP method or the books and records method, the rules of §§1.861–8 through 1.861–14T must apply to properly allocate or apportion amounts of expenses, losses and other deductions allocated and apportioned to such gross income between gross income from sources within and without the United States. In the case of gross income from Section 863 Sales determined under the 50/50 method, the amounts of expenses, losses, and other deductions allocated and apportioned to such gross income must be apportioned between sources within and without the United States pro rata based on the relative amounts of gross income from sources within and without the United States determined under the 50/50 method. Research and experimental expenditures qualifying under §1.861–17 are allocated under that section, and are not allocated and apportioned pro rata under the 50/50 method.

(e) *Election and reporting rules*—(1) *Elections under paragraph (b) of this section.* If a taxpayer does not elect a method specified in paragraph (b) (2) or (3) of this section, the taxpayer must apply the method specified in paragraph (b)(1) of this section. The taxpayer may elect to apply the method specified in paragraph (b)(2) of this section by using the method on a timely filed original return (including extensions). A taxpayer may elect to apply the method specified in paragraph (b)(3) of this section by using the method on a timely filed original return (including extensions), but only if the taxpayer has received permission from the District Director to apply that method. Once a method under paragraph (b) of this section has been used, that method must be used in later taxable years unless the Commissioner consents to a change. However, if a taxpayer elects to change to or from the method specified in paragraph (b)(3) of this section, the taxpayer must obtain permission from the District Director instead of the Commissioner. Permission to change methods from one year to another year will not be withheld unless the change would result in a substantial distortion of the source of the taxpayer's income.

(2) *Disclosure on tax return.* A taxpayer who uses one of the methods described in paragraph (b) of this section must fully explain in a statement attached to the return the methodology used, the circumstances justifying use of that methodology, the extent that sales are aggregated, and the amount of income so allocated.

(f) *Income partly from sources within a possession of the United States*—(1) *In general.* This paragraph (f) relates to gains, profits, and income, which are treated as derived partly from sources within the United States and partly from sources within a possession of the United States (Section 863 Possession Sales). This paragraph (f) applies to determine the source of income derived from the sale of inventory produced (in whole or in part) by the taxpayer within the United States and sold within a possession, or produced (in whole or in

part) by a taxpayer in a possession and sold within the United States (Possession Production Sales). It also applies to determine the source of income derived from the purchase of personal property within a possession of the United States and its sale within the United States (Possession Purchase Sales). A taxpayer subject to this paragraph (f) must divide gross income from Section 863 Possession Sales using one of the methods described in either paragraph (f)(2)(i) of this section (in the case of Possession Production Sales) or paragraph (f)(3)(i) of this section (in the case of Possession Purchase Sales). Once a taxpayer has elected a method, the taxpayer must separately apply that method to the applicable category of Section 863 Possession Sales in the United States and to those in a possession. The source of gross income from each type of activity must then be determined under either paragraph (f)(2)(ii) or (3)(ii) of this section, as appropriate. The source of taxable income from Section 863 Possession Sales is determined under paragraph (f)(4) of this section. The taxpayer must apply the rules for computing gross and taxable income by aggregating all Section 863 Possession Sales to which a method in this section applies after separately applying that method to Section 863 Possession Sales in the United States and to Section 863 Possession Sales in a possession. This section does not apply to determine the source of a taxpayer's gross income derived from a sale of inventory purchased from a corporation that has an election in effect under section 936, if the taxpayer's income from sales of that inventory is taken into account to determine benefits under section 936 for the section 936 corporation. For rules to be applied to determine the source of such income, see §1.936–6(a)(5) Q&A 7a and 1.936–6(b)(1) Q&A 13.

(2) *Allocation or apportionment for Possession Production Sales*—(i) *Methods for determining the source of gross income for Possession Production Sales*—(A) *Possession 50/50 method*. Under the possession 50/50 method, gross income from Possession Production Sales is allocated between production activity and business sales activity as described in this paragraph (f)(2)(i)(A). Under the possession 50/50 method, one-half of the taxpayer's gross income will be considered income attributable to production activity and the source of that income will be determined under the rules of paragraph (f)(2)(ii)(A) of this section. The remaining one-half of such gross income will be considered income attributable to business sales activity and the source of that income will be determined under the rules of paragraph (f)(2)(ii)(B) of this section.

(B) *IFP method*. In lieu of the possession 50/50 method, a taxpayer may elect the independent factory price (IFP) method. Under the IFP method, gross income from Possession Production Sales is allocated to production activity or sales activity using the IFP method, as described in paragraph (b)(2) of this section, if an IFP is fairly established under the rules of paragraph (b)(2) of this section. See paragraphs (f)(2)(ii)(A) and (C) of this section for rules for determining the source of gross income attributable to production activity and sales activity.

(C) *Books and records method*. A taxpayer may elect to allocate gross income using the books and records method described in paragraph (b)(3) of this section, if it has received in advance the permission of the District Director having audit responsibility over its return. See paragraph (f)(2)(ii) of this section for rules for determining the source of gross income.

(ii) *Determination of source of gross income from production, business sales, and sales activity*—(A) *Gross income attributable to production activity*. The source of gross income from production activity is determined under the rules of paragraph (c)(1) of this section, except that the term possession is substituted for foreign country wherever it appears.

(B) *Gross income attributable to business sales activity*—(*1*) *Source of gross income*. Gross income from the taxpayer's business sales activity is sourced in the possession in the same proportion that the amount of the taxpayer's business sales activity for the taxable year within the possession bears to the amount of the taxpayer's business sales

activity for the taxable year both within the possession and outside the possession, with respect to Possession Production Sales. The remaining income is sourced in the United States.

(*2*) *Business sales activity*. For purposes of this paragraph (f)(2)(ii)(B), the taxpayer's business sales activity is equal to the sum of—

(*i*) The amounts for the taxable period paid for wages, salaries, and other compensation of employees, and other expenses attributable to Possession Production Sales (other than amounts that are nondeductible under section 263A, interest, and research and development); and

(*ii*) Possession Production Sales for the taxable period.

(*3*) *Location of business sales activity*. For purposes of determining the location of the taxpayer's business activity within a possession, the following rules apply:

(*i*) *Sales*. Receipts from gross sales will be attributed to a possession under the provisions of paragraph (c)(2) of this section.

(*ii*) *Expenses*. Expenses will be attributed to a possession under the rules of §§ 1.861–8 through 1.861–14T.

(C) *Gross income attributable to sales activity*. The source of the taxpayer's income that is attributable to sales activity, as determined under the IFP method or the books and records method, will be determined under the provisions of paragraph (c)(2) of this section.

(3) *Allocation or apportionment for Possession Purchase Sales*—(i) *Methods for determining the source of gross income for Possession Purchase Sales*—(A) *Business activity method*. Gross income from Possession Purchase Sales is allocated in its entirety to the taxpayer's business activity, and is then apportioned between U.S. and possession sources under paragraph (f)(3)(ii) of this section.

(B) *Books and records method*. A taxpayer may elect to allocate gross income using the books and records method described in paragraph (b)(3) of this section, subject to the conditions set forth in paragraph (b)(3) of this section. See paragraph (f)(2)(ii) of this section for rules for determining the source of gross income.

(ii) *Determination of source of gross income from business activity*—(A) *Source of gross income*. Gross income from the taxpayer's business activity is sourced in the possession in the same proportion that the amount of the taxpayer's business activity for the taxable year within the possession bears to the amount of the taxpayer's business activity for the taxable year both within the possession and outside the possession, with respect to Possession Purchase Sales. The remaining income is sourced in the United States.

(B) *Business activity*. For purposes of this paragraph (f)(3)(ii), the taxpayer's business activity is equal to the sum of—

(*1*) The amounts for the taxable period paid for wages, salaries, and other compensation of employees, and other expenses attributable to Possession Purchase Sales (other than amounts that are nondeductible under section 263A, interest, and research and development);

(*2*) Cost of goods sold attributable to Possession Purchase Sales during the taxable period; and

(*3*) Possession Purchase Sales for the taxable period.

(C) *Location of business activity*. For purposes of determining the location of the taxpayer's business activity within a possession, the following rules apply:

(*1*) *Sales*. Receipts from gross sales will be attributed to a possession under the provisions of paragraph (c)(2) of this section.

(*2*) *Cost of goods sold*. Payments for cost of goods sold will be properly attributable to gross receipts from sources within the possession only to the extent that the property purchased was manufactured, produced, grown, or extracted in the possession (within the meaning of section 954(d)(1)(A)).

(*3*) *Expenses*. Expenses will be attributed to a possession under the rules of §§ 1.861–8 through 1.861–14T.

(iii) *Examples*. The following examples illustrate the rules of paragraph (f)(3)(ii) of this section relating to the determination of source of gross income from business activity:

Example 1. (i) U.S. Co. purchases in a possession product X for $80 from A. A manufactures X in the possession. Without further production, U.S. Co. sells X in the United

States for $100. Assume U.S. Co. has sales and administrative expenses in the possession of $10.

(ii) To determine the source of U.S. Co.'s gross income, the $100 gross income from sales of X is allocated entirely to U.S. Co.'s business activity. Forty-seven dollars of U.S. Co.'s gross income is sourced in the possession. [Possession expenses ($10) plus possession purchases (i.e., cost of goods sold) ($80) plus possessions sales ($0), divided by total expenses ($10) plus total purchases ($80) plus total sales ($100).] The remaining $53 is sourced in the United States.

Example 2. (i) Assume the same facts as in *Example 1*, except that A manufactures X outside the possession.

(ii) To determine the source of U.S. Co.'s gross income, the $100 gross income is allocated entirely to U.S. Co.'s business activity. Five dollars of U.S. Co.'s gross income is sourced in the possession. [Possession expenses ($10) plus possession purchases ($0) plus possession sales ($0), divided by total expenses ($10) plus total purchases ($80) plus total sales ($100).] The $80 purchase is not included in the numerator used to determine U.S. Co.'s business activity in the possession, since product X was not manufactured in the possession. The remaining $95 is sourced in the United States.

(4) *Determination of source of taxable income.* Once the source of gross income has been determined under paragraph (f)(2) or (3) of this section, the taxpayer must properly allocate and apportion separately under §§1.861–8 through 1.861–14T the amounts of its expenses, losses, and other deductions to its respective amounts of gross income from Section 863 Possession Sales determined separately under each method described in paragraph (f)(2) or (3) of this section. In addition, if the taxpayer deducts expenses for research and development under section 174 that may be attributed to its Section 863 Possession Sales under §1.861–17, the taxpayer must separately allocate or apportion expenses, losses, and other deductions to its respective amounts of gross income from each relevant product category that the taxpayer uses in applying the rules of §1.861–17. Thus, in the case of gross income from Section 863 Possession Sales determined under the IFP method or books and records method, a taxpayer must apply the rules of §§1.861–8 through 1.861–14T to properly allocate or apportion amounts of expenses, losses and other deductions, allocated and apportioned to such gross income, between gross income from sources within and without the United States. However, in the case of gross income from Possession Production Sales determined under the possessions 50/50 method or gross income from Possession Purchase Sales computed under the business activity method, the amounts of expenses, losses, and other deductions allocated and apportioned to such gross income must be apportioned between sources within and without the United States pro rata based on the relative amounts of gross income from sources within and without the United States determined under those methods, except that the rules regarding the allocation and apportionment of research and experimental expenditures in §1.861–17 shall apply to such expenditures of taxpayers using the 50/50 method.

(5) *Special rules for partnerships.* In applying the rules of this paragraph (f) to transactions involving partners and partnerships, the rules of paragraph (g) of this section apply.

(6) *Election and reporting rules*—(i) *Elections under paragraph (f)(2) or (3) of this section.* If a taxpayer does not elect one of the methods specified in paragraph (f)(2) or (3) of this section, the taxpayer must apply the possession 50/50 method in the case of Possession Production Sales or the business activity method in the case of Possession Purchase Sales. The taxpayer may elect to apply a method specified in either paragraph (f)(2) or (3) of this section by using the method on a timely filed original return (including extensions). Once a method has been used, that method must be used in later taxable years unless the Commissioner consents to a change. Permission to change methods from one year to another year will be granted unless the change would result in a substantial distortion of the source of the taxpayer's income.

(ii) *Disclosure on tax return.* A taxpayer who uses one of the methods described in paragraph (f)(2) or (3) of this section must fully explain in a statement attached to the tax return the methodology used, the circumstances justifying use of that methodology, the extent that sales are aggregated, and the amount of income so allocated.

(g) *Special rules for partnerships*—(1) *General rule*. For purposes of § 1.863–1 and this section, a taxpayer's production or sales activity does not include production and sales activities conducted by a partnership of which the taxpayer is a partner either directly or through one or more partnerships, except as otherwise provided in paragraph (g)(2) of this section.

(2) *Exceptions*—(i) *In general*. For purposes of determining the source of the partner's distributive share of partnership income or determining the source of the partner's income from the sale of inventory property which the partnership distributes to the partner in kind, the partner's production or sales activity includes an activity conducted by the partnership. In addition, the production activity of a partnership includes the production activity of a taxpayer that is a partner either directly or through one or more partnerships, to the extent that the partner's production activity is related to inventory that the partner contributes to the partnership in a transaction described under section 721.

(ii) *Attribution of production assets to or from a partnership*. A partner will be treated as owning its proportionate share of the partnership's production assets only to the extent that, under paragraph (g)(2)(i) of this section, the partner's activity includes production activity conducted through a partnership. A partner's share of partnership assets will be determined by reference to the partner's distributive share of partnership income for the year attributable to such production assets. Similarly, to the extent a partnership's activities include the production activities of a partner, the partnership will be treated as owning the partner's production assets related to the inventory that is contributed in kind to the partnership. See paragraph (c)(1)(ii)(B) of this section for rules apportioning the basis of assets to Section 863 Sales.

(iii) *Basis*. For purposes of this section, in those cases where the partner is treated as owning its proportionate share of the partnership's production assets, the partner's basis in production assets held through a partnership shall be determined by reference to the partnership's adjusted basis in its assets (including a partner's special basis adjustment, if any, under section 743). Similarly, a partnership's basis in a partner's production assets is determined with reference to the partner's adjusted basis in its assets.

(iv) *Separate application of methods*. If, under paragraph (g)(2) of this section, a partner is treated as conducting the activity of a partnership, and is treated as owning its proportionate share of a partnership's production assets, a partner must apply the method it has elected under paragraph (b) of this section separately to Section 863 Sales described in this paragraph (g) and all other Section 863 Sales.

(3) *Examples*. The following examples illustrate the rules of this paragraph (g):

Example 1. Distributive share of partnership income. A, a U.S. corporation, forms a partnership in the United States with B, a country X corporation. A and B each have a 50 percent interest in the income, gains, losses, deductions and credits of the partnership. The partnership is engaged in the manufacture and sale of widgets. The widgets are manufactured in the partnership's plant located in the United States and are sold by the partnership outside the United States. The partnership owns the manufacturing facility and all other production assets used to produce the widgets. A's distributive share of partnership income includes 50 percent of the sales income from these sales. In applying the rules of section 863 to determine the source of its distributive share of partnership income from the export sales of widgets, A is treated as carrying on the activity of the partnership related to production of these widgets and as owning a proportionate share of the partnership's assets related to production of the widgets, based upon its distributive share of partnership income.

Example 2. Distribution in kind. Assume the same facts as in *Example 1* except that the partnership, instead of selling the widgets, distributes the widgets to A and B. A then further processes the widgets and then sells them outside the United States. In determining the source of the income earned by A on the sales outside the United States, A is treated as conducting the activities of the partnership related to production of the distributed widgets. Thus, the source of gross income on the sale of the widgets is determined under section 863 and these regulations. A applies the 50/50 method described in paragraph (b)(1) of this section to determine the source of income from the sales. In applying paragraph (c)(1) of this section, A is treated as owning its proportionate share of the partnership's production assets based

upon its distributive share of partnership income.

(h) *Effective dates*. The rules of this section apply to taxable years beginning after December 30, 1996. However, taxpayers may apply these regulations for taxable years beginning after July 11, 1995, and on or before December 30, 1996. For years beginning before December 30, 1996, see §§ 1.863–3A and 1.863–3AT. However, the rules of paragraph (f) of this section apply to taxable years beginning on or after November 13, 1998.

[T.D. 8687, 61 FR 60547, Nov. 29, 1996; 61 FR 65323, Dec. 12, 1996, as amended by T.D. 8786, 63 FR 55023, Oct. 14, 1998; T.D. 9305, 71 FR 77603, Dec. 27, 2006]

REGULATIONS APPLICABLE TO TAXABLE YEARS PRIOR TO DECEMBER 30, 1996

§ 1.863–3A Income from the sale of personal property derived partly from within and partly from without the United States.

(a) *General*—(1) *Classes of income*. Income from the sale of property to which paragraph (b) (2) and (3) of § 1.863–2 applies is divided into two classes for purposes of this section, namely, income which is treated as derived partly from sources within the United States and partly from sources within a foreign country, and income which is treated as derived partly from sources within the United States and partly from sources within a possession of the United States.

(2) *Definition*. For purposes of this section, the word ''produced'' includes created, fabricated, manufactured, extracted, processed, cured, or aged. For determining the time and place of sale of personal property for purposes of this section, see paragraph (c) of § 1.861–7.

(b) *Income partly from sources within a foreign country*—(1) *General*. This paragraph relates to gains, profits, and income derived from the sale of personal property produced (in whole or in part) by the taxpayer within the United States and sold within a foreign country, or produced (in whole or in part) by the taxpayer within a foreign country and sold within the United States. Pursuant to section 863(b) such items shall be treated as derived partly from sources within the United States and partly from sources within a foreign country.

(2) *Allocation or apportionment*. The taxable income from sources within the United States, in the case of the items to which this paragraph applies, shall be determined according to the examples set forth in this subparagraph. For such purposes, the deductions for the personal exemptions shall not be taken into account, but the special deductions described in paragraph (c) of § 1.861–8 shall be taken into account.

Example 1. Where the manufacturer or producer regularly sells part of his output to wholly independent distributors or other selling concerns in such a way as to establish fairly an independent factory or production price—or shows to the satisfaction of the district director (or, if applicable, the Director of International Operations) that such an independent factory or production price has been otherwise established—unaffected by considerations of tax liability and the selling or distributing branch or department of the business is located in a different country from that in which the factory is located or the production carried on, the taxable income attributable to sources within the United States shall be computed by an accounting which treats the products as sold by the factory or productive department of the business to the distributing or selling department at the independent factory price so established. In all such cases the basis of the accounting shall be fully explained in a statement attached to the return for the taxable year.

Example 2. (i)–(ii) [Reserved]. For guidance, see § 863–3T(b)(2) *Example* (2)(i) and (ii).

(iii) The term ''gross sales'', as used in this example, refers only to the sales of personal property produced (in whole or in part) by the taxpayer within the United States and sold within a foreign country or produced (in whole or in part) by the taxpayer within a foreign country and sold within the United States.

(iv) The term ''property'', as used in this example, includes only the property held or used to produce income which is derived from such sales. Such property should be taken at its actual value, which in the case of property valued or appraised for purposes of inventory, depreciation, depletion, or other purposes of taxation shall be the highest amount at which so valued or appraised, and which in other cases shall be deemed to be its book value in the absence of affirmative evidence showing such value to be greater or less than the actual value. The average value during the taxable year or period shall be employed. The average value of property

as above prescribed at the beginning and end of the taxable year or period ordinarily may be used, unless by reason of material changes during the taxable year or period such average does not fairly represent the average for such year or period, in which event the average shall be determined upon a monthly or daily basis.

(v) Bills and accounts receivable shall (unless satisfactory reason for a different treatment is shown) be assigned or allocated to the United States when the debtor resides in the United States, unless the taxpayer has no office, branch, or agent in the United States.

Example 3. Application for permission to base the return upon the taxpayer's books of account will be considered by the district director (or, if applicable, the Director of International Operations) in the case of any taxpayer who, in good faith and unaffected by considerations of tax liability, regularly employs in his books of account a detailed allocation of receipts and expenditures which reflects more clearly than the processes or formulas herein prescribed the taxable income derived from sources within the United States.

(c) *Income partly from sources within a possession of the United States*—(1) *General.* This paragraph relates to gains, profits, and income which, pursuant to section 863(b), are treated as derived partly from sources within the United States and partly from sources within a possession of the United States. The items so treated are described in subparagraphs (3) and (4) of this paragraph.

(2) *Allocation or apportionment.* The taxable income from sources within the United States, in the case of the items to which this paragraph applies, shall be determined according to the examples set forth in subparagraphs (3) and (4) of this paragraph. For such purposes, the deductions for the personal exemptions shall not be taken into account, but the special deductions described in paragraph (c) of §1.861–8 shall be taken into account.

(3) *Personal property produced and sold.* This subparagraph relates to gross income derived from the sale of personal property produced (in whole or in part) by the taxpayer within the United States and sold within a possession of the United States, or produced (in whole or in part) by the taxpayer within a possession of the United States and sold within the United States.

Example 1. Same as example 1 under paragraph (b)(2) of this section.

Example 2. (i) Where an independent factory or production price has not been established as provided under example 1, the taxable income shall first be computed by deducting from the gross income derived from the sale of personal property produced (in whole or in part) by the taxpayer within the United States and sold within a possession of the United States, or produced (in whole or in part) by the taxpayer within a possession of the United States and sold within the United States, the expenses, losses, or other deductions properly allocated and apportioned thereto in accordance with the rules set forth in §1.861–8.

(ii) Of the amount of taxable income so determined, one-half shall be apportioned in accordance with the value of the taxpayer's property within the United States and within the possession of the United States, the portion attributable to sources within the United States being determined by multiplying such one-half by a fraction the numerator of which consists of the value of the taxpayer's property within the United States, and the denominator of which consists of the value of the taxpayer's property both within the United States and within the possession of the United States. The remaining one-half of such taxable income shall be apportioned in accordance with the total business of the taxpayer within the United States and within the possession of the United States, the portion attributable to sources within the United States being determined by multiplying such one-half by a fraction the numerator of which consists of the amount of the taxpayer's business for the taxable year or period within the United States, and the denominator of which consists of the amount of the taxpayer's business for the taxable year or period both within the United States and within the possession of the United States.

(iii) ''The business of the taxpayer'', as used in this example, shall be measured by the amounts which the taxpayer paid out during the taxable year or period for wages, salaries, and other compensation of employees and for the purchase of goods, materials, and supplies consumed in the regular course of business, plus the amounts received during the taxable year or period from gross sales, such expenses, purchases, and gross sales being limited to those attributable to the production (in whole or in part) of personal property within the United States and its sale within a possession of the United States or to the production (in whole or in part) of personal property within a possession of the United States and its sale within the United States. The term ''property'', as used in this example, includes only the property held or used to produce income which is derived from such sales.

Example 3. Same as example 3 under paragraph (b)(2) of this section.

(4) *Personal property purchased and sold.* This subparagraph relates to gross income derived from the purchase of personal property within a possession of the United States and its sale within the United States.

Example 1. (i) The taxable income shall first be computed by deducting from such gross income the expenses, losses, or other deductions properly allocated or apportioned thereto in accordance with the rules set forth in § 1.861–8.

(ii) The amount of taxable income so determined shall be apportioned in accordance with the total business of the taxpayer within the United States and within the possession of the United States, the portion attributable to sources within the United States being that percentage of such taxable income which the amount of the taxpayer's business for the taxable year or period within the United States bears to the amount of the taxpayer's business for the taxable year or period both within the United States and within the possession of the United States.

(iii) The ''business of the taxpayer'', as that term is used in this example, shall be measured by the amounts which the taxpayer paid out during the taxable year or period for wages, salaries, and other compensation of employees and for the purchase of goods, materials, and supplies sold or consumed in the regular course of business, plus the amount received during the taxable year or period from gross sales, such expenses, purchases, and gross sales being limited to those attributable to the purchase of personal property within a possession of the United States and its sale within the United States.

Example 2. Same as example 3 under paragraph (b)(2) of this section.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 7456, 42 FR 1214, Jan. 6, 1977; T.D. 8228, 53 FR 35506, Sept. 14, 1988. Redesignated by T.D. 8687, 61 FR 60545, Nov. 29, 1996]

§ 1.863–3AT Income from the sale of personal property derived partly from within and partly from without the United States (temporary regulations).

(a) [Reserved]

(b) *Income partly from sources within a foreign country.* (1) [Reserved]

(2) *Allocation or apportionment.*

Example 1. [Reserved]

Example 2. (i) Where an independent factory or production price has not been established as provided under *Example* (1), the gross income derived from the sale of personal property produced (in whole or in part) by the taxpayer within the United States and sold within a foreign country or produced (in whole or in part) by the taxpayer within a foreign country and sold within the United States shall be computed.

(ii) Of this gross amount, one-half shall be apportioned in accordance with the value of the taxpayer's property within the United States and within the foreign country, the portion attributable to sources within the United States being determined by multiplying such one-half by a fraction, the numerator of which consists of the value of the taxpayer's property within the United States and the denominator of which consists of the value of the taxpayer's property both within the United States and within the foreign country. The remaining one-half of such gross income shall be apportioned in accordance with the gross sales of the taxpayer within the United States and within the foreign country, the portion attributable to sources within the United States being determined by multiplying such one-half by a fraction the numerator of which consists of the taxpayer's gross sales for the taxable year or period within the United States, and the denominator of which consists of the taxpayer's gross sales for the taxable year or period both within the United States and within the foreign country. Deductions from gross income that are allocable and apportionable to gross income described in paragraph (i) of this *Example* 2 shall be apportioned between the United States and foreign source portions of such income, as determined under this paragraph (ii), on a pro rata basis, without regard to whether the deduction relates primarily or exclusively to the production of property or to the sale of property.

(b)(2) *Example* (2)(iii) through (c)(4) [Reserved]

[T.D. 8228, 53 FR 35506, Sept. 14, 1988. Redesignated by T.D. 8687, 61 FR 60545, Nov. 29, 1996]

§ 1.863–4 Certain transportation services.

(a) *General.* A taxpayer carrying on the business of transportation service (other than an activity giving rise to transportation income described in section 863(c) or to income subject to other specific provisions of this title) between points in the United States and points outside the United States derives income partly from sources within and partly from sources without the United States.

(b) *Gross income.* The gross income from sources within the United States

derived from such services shall be determined by taking such a portion of the total gross revenues therefrom as (1) the sum of the costs or expenses of such transportation business carried on by the taxpayer within the United States and a reasonable return upon the property used in its transportation business while within the United States bears to (2) the sum of the total costs or expenses of such transportation business carried on by the taxpayer and a reasonable return upon the total property used in such transportation business. Revenues from operations incidental to transportation services, such as the sale of money orders, shall be apportioned on the same basis as direct revenues from transportation services.

(c) *Allocation of costs or expenses.* In allocating the total costs or expenses incurred in such transportation business, costs or expenses incurred in connection with that part of the services which was wholly rendered in the United States shall be assigned to the cost of transportation business within the United States. For example, expenses of loading and unloading in the United States, rentals, office expenses, salaries, and wages wholly incurred for services rendered to the taxpayer in the United States belong to this class. Costs and expenses incurred in connection with services rendered partly within and partly without the United States may be prorated on a reasonable basis between such services. For example, ship wages, charter money, insurance, and supplies chargeable to voyage expenses shall ordinarily be prorated for each voyage on the basis of the proportion which the number of days the ship was within the territorial limits of the United States bears to the total number of days on the voyage; and fuel consumed on each voyage may be prorated on the basis of the proportion which the number of miles sailed within the territorial limits of the United States bears to the total number of miles sailed on the voyage. For other expenses entering into the cost of services, only such expenses as are allowable deductions under the internal revenue laws shall be taken into account.

(d) *Items not included as costs or expenses*—(1) *Taxes and interest.* Income, war profits, and excess profits taxes shall not be regarded as costs or expenses for the purpose of determining the proportion of gross income from sources within the United States; and, for such purpose, interest and other expenses for the use of borrowed capital shall not be taken into the cost of services rendered, for the reason that the return upon the property used measures the extent to which such borrowed capital is the source of the income. See paragraph (f)(2) of this section.

(2) *Other business activity and general expenses.* If a taxpayer subject to this section is also engaged in a business other than that of providing transportation service between points in the United States and points outside the United States, the costs and expenses, including taxes, properly apportioned or allocated to such other business shall be excluded both from the deductions and from the apportionment process prescribed in paragraph (c) of this section; but, for the purpose of determining taxable income, a ratable part of any general expenses, losses, or deductions, which cannot definitely be allocated to some item or class of gross income, may be deducted from the gross income from sources within the United States after the amount of such gross income has been determined. Such ratable part shall ordinarily be based upon the ratio of gross income from sources within the United States to the total gross income. See paragraph (f)(3) of this section.

(3) *Personal exemptions and special deductions.* The deductions for the personal exemptions, and the special deductions described in paragraph (c) of §1.861–8, shall not be taken into account for purposes of paragraph (c) of this section.

(e) *Property used while within the United States*—(1) *General.* The value of the property used shall be determined upon the basis of cost less depreciation. Eight percent may ordinarily be taken as a reasonable rate of return to apply to such property. The property taken shall be the average property employed in the transportation service between points in the United States and points

outside the United States during the taxable year.

(2) *Average property*. For ships, the average shall be determined upon a daily basis for each ship, and the amount to be apportioned for each ship as assets employed within the United States shall be computed upon the proportion which the number of days the ship was within the territorial limits of the United States bears to the total number of days the ship was in service during the taxable period. For other assets employed in the transportation business, the average of the assets at the beginning and end of the taxable period ordinarily may be taken, but if the average so obtained does not, by reason of material changes during the taxable year, fairly represent the average for such year either for the assets employed in the transportation business in the United States or in total, the average must be determined upon a monthly or daily basis.

(3) *Current assets*. Current assets shall be decreased by current liabilities and allocated to services between the United States and foreign countries and to other services. The part allocated to services between the United States and foreign countries shall be based on the proportion which the gross receipts from such services bear to the gross receipts from all services. The amount so allocated to services between the United States and foreign countries shall be further allocated to services rendered within the United States and to services rendered without the United States. The portion allocable to services rendered within the United States shall be based on the proportion which the expenses incurred within the territorial limits of the United States bear to the total expenses incurred in services between the United States and foreign countries.

(f) *Taxable income*—(1) *General*. In computing taxable income from sources within the United States there shall be allowed as deductions from the gross income from such sources, determined in accordance with paragraph (b) of this section, (i) the expenses of the transportation business carried on within the United States (as determined under paragraphs (c) and (d) of this section) and (ii) the expenses and deductions determined in accordance with this paragraph.

(2) *Interest and taxes*. Interest and income, war-profits, and excess profits taxes shall be excluded from the apportionment process, as indicated in paragraph (d) of this section; but, for the purpose of computing taxable income there may be deducted from the gross income from sources within the United States, after the amount of such gross income has been determined, a ratable part of all interest deductible under section 163 and of all income, war-profits, and excess profits taxes deductible under section 164, paid or accrued in respect of the business of transportation service between points in the United States and points outside the United States. The ratable part shall ordinarily be based upon the ratio of gross income from sources within the United States to the total gross income, from such transportation service.

(3) *General expenses*. General expenses, losses, or deductions shall be deducted under this paragraph to the extent indicated in paragraph (d)(2) of this section.

(4) *Personal exemptions*. The deductions for the personal exemptions shall be allowed under this paragraph to the same extent as provided by paragraph (b) of § 1.861–8.

(5) *Special deductions*. The special deductions allowed in the case of a corporation by sections 241, 922, and 941 shall be allowed under this paragraph to the same extent as provided by paragraph (c) of § 1.861–8.

(g) *Allocation based on books of account*. Application for permission to base the return upon the taxpayer's books of account will be considered by the district director (or, if applicable, the Director of International Operations) in the case of any taxpayer subject to this section, who, in good faith and unaffected by considerations of tax liability, regularly employs in his books of account a detailed allocation of receipts and expenditures which more clearly reflects the income derived from sources within the United States than does the process prescribed

by paragraphs (b) to (f), inclusive, of this section.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 8687, 61 FR 60550, Nov. 29, 1996]

§ 1.863–6 Income from sources within a foreign country.

The principles applied in sections 861 through 863 and section 865 and the regulations thereunder for determining the gross and the taxable income from sources within and without the United States shall generally be applied in determining the gross and the taxable income from sources within and without a particular foreign country when such a determination must be made under any provision of Subtitle A of the Internal Revenue Code, including section 952(a)(5). This section shall not apply, however, to the extent it is determined by applying §1.863–3 that a portion of the taxable income is from sources within the United States and the balance of the taxable income is from sources within a foreign country. In the application of this section, the name of the particular foreign country shall be used instead of the term *United States*, and the term *domestic* shall be construed to mean created or organized in such foreign country. In applying section 861 and the regulations thereunder for purposes of this section, references to sections 243 and 245 shall be excluded, and the exception in section 861(a)(3) shall not apply. In the case of any item of income, the income from sources within a foreign country shall not exceed the amount which, by applying any provision of sections 861 through 863 and section 865 and the regulations thereunder without reference to this section, is treated as income from sources without the United States. See §1.937–2T for rules for determining income from sources within a possession of the United States.

[T.D. 9194, 70 FR 18928, Apr. 11, 2005]

§ 1.863–7 Allocation of income attributable to certain notional principal contracts under section 863(a).

(a) *Scope*—(1) *Introduction*. This section provides rules relating to the source and, in certain cases, the character of notional principal contract income. However, this section does not apply to income from a section 988 transaction within the meaning of section 988 and the regulations thereunder, relating to the treatment of certain nonfunctional currency transactions. Further, this section does not apply to a dividend equivalent described in section 871(m) and the regulations thereunder. Notional principal contract income is income attributable to a notional principal contract as defined in §1.446–3(c). An agreement between a taxpayer and a qualified business unit (as defined in section 989(a)) of the taxpayer, or among qualified business units of the same taxpayer, is not a notional principal contract, because a taxpayer cannot enter into a contract with itself.

(2)*Effective/applicability date*.This section applies to notional principal contract income includible in income on or after February 13, 1991. However, any taxpayer desiring to apply paragraph (b)(2)(iv) of this section to notional principal contract income includible in income prior to February 13, 1991, in lieu of temporary Income Tax Regulations §1.863–7T(b)(2)(iv) may (on a consistent basis) so choose. See paragraph (c) of this section for an election to apply the rules of this section to notional principal contract income includible in income before December 24, 1986. With respect to a dividend equivalent described in section 871(m) and the regulations thereunder, this section applies to payments made on or after January 23, 2012.

(b) *Source of notional principal contract income*—(1) *General rule*. Unless paragraph (b) (2) or (3) of this section applies, the source of notional principal contract income shall be determined by reference to the residence of the taxpayer as determined under section 988(a)(3)(B)(i).

(2) *Qualified business unit exception*. The source of notional principal contract income shall be determined by reference to the residence of a qualified business unit of a taxpayer if—

(i) The taxpayer's residence, determined under section 988(a)(3)(B)(i), is the United States;

(ii) The qualified business unit's residence, determined under section 988(a)(3)(B)(ii), is outside the United States;

(iii) The qualified business unit is engaged in the conduct of a trade or business where it is a resident as determined under section 988(a)(3)(B)(ii); and

(iv) The notional principal contract is properly reflected on the books of the qualified business unit. Whether a notional principal contract is properly reflected on the books of such qualified business unit is a question of fact. The degree of participation in the negotiation and acquisition of a notional principal contract shall be considered in this determination. Participation in connection with the negotiation or acquisition of a notional principal contract may be disregarded if the district director determines that a purpose for such participation was to affect the source of notional principal contract income.

(3) *Effectively connected notional principal contract income.* Notional principal contract income that under principles similar to those set forth in §1.864–4(c) arises from the conduct of a United States trade or business shall be sourced in the United States and such income shall be treated as effectively connected to the conduct of a United States trade or business for purposes of sections 871(b) and 882(a)(1).

(c) *Election*—(1) *Eligibility and effect.* A taxpayer described in paragraph (b)(2)(i) of this section may make an election to apply the rules of this section to all, but not part, of the taxpayer's income attributable to notional principal contracts for all taxable years (or portion thereof) beginning before December 24, 1986, for which the period of limitations for filing a claim for refund under section 6511(a) has not expired. A taxpayer not described in paragraph (b)(2)(i) of this section that is engaged in trade or business within the United States may make an election to apply the rules of this section to all, but not part, of the taxpayer's income described in paragraph (b)(3) of this section for all taxable years (or portion thereof) beginning before December 24, 1986, for which the period of limitations for filing a claim for refund under section 6511(a) has not expired. If a taxpayer makes an election pursuant to this paragraph (c)(1) in the time and manner provided in paragraph (c) (2) and (3) of this section, then, with respect to such taxable years (or portion thereof), no tax shall be deducted or withheld under sections 1441 and 1442 with respect to payments made by the taxpayer pursuant to a notional principal contract the income attributable to which is subject to such election. The election may be revoked only with the consent of the Commissioner.

(2) *Time for making election.* The election specified in paragraph (c)(1) of this section shall be made by May 14, 1991.

(3) *Manner of making election.* The election described in paragraph (c)(1) of this section shall be made by attaching a statement to the tax return or an amended tax return for each taxable year beginning before December 24, 1986, in which the taxpayer accrued or received notional principal contract income. The statement shall—

(i) Contain the name, address, and taxpayer identifying number of the electing taxpayer;

(ii) Identify the election as a ''Notional Principal Contract Election under §1.863–7''; and

(iii) Specify each taxable year described in paragraph (c)(1) of this section in which payments were made.

(d) *Example.* The operation of this section is illustrated by the following example:

Example. (1) On January 1, 1990, X, a calendar year domestic corporation, entered into an interest rate swap contract with FZ, an unrelated foreign corporation. X does not have a qualified business unit outside the United States. Under the contract, X is required to pay FZ fixed rate dollar amounts, and FZ is required to pay X floating rate dollar amounts, each determined solely by reference to a notional dollar denominated principal amount specified under the contract. The contract is a notional principal contract under §1.863–7(a) because the contract provides for the payment of amounts at specified intervals calculated by reference to a specified index upon a notional principal amount in exchange for a promise to pay similar amounts.

(2) Assume that during 1990 X had notional principal contract income of $100 in connection with the notional principal contract described in (1) above. Also assume that the contract provides that payments more than 30 days late give rise to a $5 fee, and that X receives such a fee in 1990. Under paragraph (b)(1) of this section, the source of X's $100 of income attributable to the swap agreement is domestic. The $5 fee is not notional principal contract income.

(e) *Cross references.* See §1.861–9T(b) for the allocation of expense to certain notional principal contracts. For rules relating to the source of income from nonfunctional currency notional principal contracts, see §1.9 88–4T. For rules relating to the taxable amount of notional principal contract income allocable under this section to sources inside or outside the United States, see §1.863–1(c).

[T.D. 8330, 56 FR 1362, Jan. 14, 1991, as amended by T.D. 9572, 77 FR 3109, Jan. 23, 2012; T.D. 9648, 78 FR 73080, Dec. 5, 2013]

§1.863–8 Source of income derived from space and ocean activity under section 863(d).

(a) *In general.* Income of a United States or a foreign person derived from space and ocean activity (space and ocean income) is sourced under the rules of this section, notwithstanding any other provision, including sections 861, 862, 863, and 865. A taxpayer will not be considered to derive income from space or ocean activity, as defined in paragraph (d) of this section, if such activity is performed by another person, subject to the rules for the treatment of consolidated groups in §1.1502–13.

(b) *Source of gross income from space and ocean activity*—(1) *Space and ocean income derived by a United States person.* Space and ocean income derived by a United States person is income from sources within the United States. However, space and ocean income derived by a United States person is income from sources without the United States to the extent the income, based on all the facts and circumstances, is attributable to functions performed, resources employed, or risks assumed in a foreign country or countries.

(2) *Space and ocean income derived by a foreign person*—(i) *In general.* Space and ocean income derived by a person other than a United States person is income from sources without the United States, except as otherwise provided in this paragraph (b)(2).

(ii) *Space and ocean income derived by a controlled foreign corporation.* Space and ocean income derived by a controlled foreign corporation within the meaning of section 957 (CFC) is income from sources within the United States. However, space and ocean income derived by a CFC is income from sources without the United States to the extent the income, based on all the facts and circumstances, is attributable to functions performed, resources employed, or risks assumed in a foreign country or countries.

(iii) *Space and ocean income derived by foreign persons engaged in a trade or business within the United States.* Space and ocean income derived by a foreign person (other than a CFC) engaged in a trade or business within the United States is income from sources within the United States to the extent the income, based on all the facts and circumstances, is attributable to functions performed, resources employed, or risks assumed within the United States.

(3) *Source rules for income from certain sales of property*—(i) *Sales of purchased property.* When a taxpayer sells purchased property in space or international water, the source of gross income from the sale generally will be determined under paragraph (b)(1) or (2) of this section, as applicable. However, if such property is inventory property within the meaning of section 1221(a)(1) (inventory property) and is sold for use, consumption, or disposition outside space and international water, the source of income from the sale will be determined under §1.861–7(c).

(ii) *Sales of property produced by the taxpayer*—(A) *General.* If the taxpayer both produces property and sells such property, the taxpayer must allocate gross income from such sales between production activity and sales activity under the 50/50 method. Under the 50/50 method, one-half of the taxpayer's gross income will be considered income allocable to production activity, and the source of that income will be determined under paragraph (b)(3)(ii)(B) or (C) of this section. The remaining one-half of such gross income will be considered income allocable to sales activity, and the source of that income will be determined under paragraph (b)(3)(ii)(D) of this section.

(B) *Production only in space or international water, or only outside space and international water.* When production occurs only in space or international

water, income allocable to production activity is sourced under paragraph (b)(1) or (2) of this section, as applicable. When production occurs only outside space and international water, income allocable to production activity is sourced under § 1.863–3(c)(1).

(C) *Production both in space or international water and outside space and international water.* When property is produced both in space or international water and outside space and international water, gross income allocable to production activity must be allocated to production occurring in space or international water and production occurring outside space and international water. Such gross income is allocated to production activity occurring in space or international water to the extent the income, based on all the facts and circumstances, is attributable to functions performed, resources employed, or risks assumed in space or international water. The balance of such gross income is allocated to production activity occurring outside space and international water. The source of gross income allocable to production activity in space or international water is determined under paragraph (b)(1) or (2) of this section, as applicable. The source of gross income allocated to production activity occurring outside space and international water is determined under § 1.863–3(c)(1).

(D) *Source of income allocable to sales activity.* When property produced by the taxpayer is sold outside space and international water, the source of gross income allocable to sales activity will be determined under §§ 1.861–7(c) and 1.863–3(c)(2). When property produced by the taxpayer is sold in space or international water, the source of gross income allocable to sales activity generally will be determined under paragraph (b)(1) or (2) of this section, as applicable. However, if such property is inventory property within the meaning of section 1221(a)(1) and is sold in space or international water for use, consumption, or disposition outside space, international water, and the United States, the source of gross income allocable to sales activity will be determined under §§ 1.861–7(c) and 1.863–3(c)(2).

(4) *Special rule for determining the source of gross income from services.* To the extent a transaction characterized as the performance of a service constitutes a space or ocean activity, as determined under paragraph (d)(2)(ii) of this section, the source of gross income derived from such transaction is determined under paragraph (b)(1) or (2) of this section.

(5) *Special rule for determining source of income from communications activity (other than income from international communications activity).* Space and ocean activity, as defined in paragraph (d) of this section, includes activity that occurs in space or international water that is characterized as a communications activity as defined in § 1.863–9(h)(1) (other than international communications activity). The source of space and ocean income that is also communications income as defined in § 1.863–9(h)(2) (but not space/ocean communications income as defined in § 1.863–9(h)(3)(v)) is determined under the rules of § 1.863–9(c), (d), and (f), as applicable, rather than under paragraph (b) of this section. The source of space and ocean income that is also space/ocean communications income as defined in § 1.863–9(h)(3)(v) is determined under the rules of paragraph (b) of this section. See § 1.863–9(e).

(c) *Taxable income.* When a taxpayer allocates gross income under paragraph (b)(1), (b)(2), (b)(3)(ii)(C), or (b)(4) of this section, the taxpayer must allocate expenses, losses, and other deductions as prescribed in §§ 1.861–8 through 1.861–14T to the class or classes of gross income that include the income so allocated in each case. A taxpayer must then apply the rules of §§ 1.861–8 through 1.861–14T to apportion properly amounts of expenses, losses, and other deductions so allocated to such gross income between gross income from sources within the United States and gross income from sources without the United States.

(d) *Space and ocean activity*—(1) *Definition*—(i) *Space activity.* In general, space activity is any activity conducted in space. For purposes of this section, space means any area not within the jurisdiction (as recognized by the United States) of a foreign country, possession of the United States, or

the United States, and not in international water. For purposes of determining space activity, the Commissioner may separate parts of a single transaction into separate transactions or combine separate transactions as part of a single transaction. Paragraph (d)(3) of this section lists specific exceptions to the general definition of space activity. Activities that constitute space activity include but are not limited to—

(A) Performance and provision of services in space, as defined in paragraph (d)(2)(ii) of this section;

(B) Leasing of equipment located in space, including spacecraft (for example, satellites) or transponders located in space;

(C) Licensing of technology or other intangibles for use in space;

(D) Production, processing, or creation of property in space, as defined in paragraph (d)(2)(i) of this section;

(E) Activity occurring in space that is characterized as communications activity (other than international communications activity) under §1.863–9(h)(1);

(F) Underwriting income from the insurance of risks on activities that produce space income; and

(G) Sales of property in space (see §1.861–7(c)).

(ii) *Ocean activity*. In general, ocean activity is any activity conducted on or under water not within the jurisdiction (as recognized by the United States) of a foreign country, possession of the United States, or the United States (collectively, in international water). For purposes of determining ocean activity, the Commissioner may separate parts of a single transaction into separate transactions or combine separate transactions as part of a single transaction. Paragraph (d)(3) of this section lists specific exceptions to the general definition of ocean activity. Activities that constitute ocean activity include but are not limited to—

(A) Performance and provision of services in international water, as defined in paragraph (d)(2)(ii) of this section;

(B) Leasing of equipment located in international water, including underwater cables;

(C) Licensing of technology or other intangibles for use in international water;

(D) Production, processing, or creation of property in international water, as defined in paragraph (d)(2)(i) of this section;

(E) Activity occurring in international water that is characterized as communications activity (other than international communications activity) under §1.863–9(h)(1);

(F) Underwriting income from the insurance of risks on activities that produce ocean income;

(G) Sales of property in international water (see §1.861–7(c));

(H) Any activity performed in Antarctica;

(I) The leasing of a vessel that does not transport cargo or persons for hire between ports-of-call (for example, the leasing of a vessel to engage in research activities in international water); and

(J) The leasing of drilling rigs, extraction of minerals, and performance and provision of services related thereto, except as provided in paragraph (d)(3)(ii) of this section.

(2) *Determining a space or ocean activity*—(i) *Production of property in space or international water*. For purposes of this section, production activity means an activity that creates, fabricates, manufactures, extracts, processes, cures, or ages property within the meaning of section 864(a) and §1.864–1.

(ii) *Special rule for performance of services*—(A) *General*. Except as provided in paragraph (d)(2)(ii)(B) of this section, if a transaction is characterized as the performance of a service, then such service will be treated as a space or ocean activity in its entirety when any part of the service is performed in space or international water. Services are performed in space or international water if functions are performed, resources are employed, or risks are assumed in space or international water, regardless of whether performed by personnel, equipment, or otherwise.

(B) *Exception to the general rule*. If the taxpayer can demonstrate the value of the service attributable to performance occurring in space or international water, and the value of the service attributable to performance occurring

outside space and international water, then such service will be treated as space or ocean activity only to the extent of the activity performed in space or international water. The value of the service is attributable to performance occurring in space or international water to the extent the performance of the service, based on all the facts and circumstances, is attributable to functions performed, resources employed, or risks assumed in space or international water. In addition, if the taxpayer can demonstrate, based on all the facts and circumstances, that the value of the service attributable to performance in space and international water is de minimis, such service will not be treated as space or ocean activity.

(3) *Exceptions to space or ocean activity*. Space or ocean activity does not include the following types of activities:

(i) Any activity giving rise to transportation income as defined in section 863(c).

(ii) Any activity with respect to mines, oil and gas wells, or other natural deposits, to the extent the mines, wells, or natural deposits are located within the jurisdiction (as recognized by the United States) of any country, including the United States and its possessions.

(iii) Any activity giving rise to international communications income as defined in §1.863–9(h)(3)(ii).

(e) *Treatment of partnerships*. This section is applied at the partner level.

(f) *Examples*. The following examples illustrate the rules of this section:

Example 1. Space activity—activity occurring on land and in space. (i) *Facts*. S, a United States person, owns satellites in orbit. S leases one of its satellites to A. S, as lessor, will not operate the satellite. Part of S's performance as lessor in this transaction occurs on land. Assume that the combination of S's activities is characterized as the lease of equipment.

(ii) *Analysis*. Because the leased equipment is located in space, the transaction is defined in its entirety as space activity under paragraph (d)(1)(i) of this section. Income derived from the lease will be sourced under paragraph (b)(1) of this section. Under paragraph (b)(1) of this section, S's space income is sourced outside the United States to the extent the income, based on all the facts and circumstances, is attributable to functions performed, resources employed, or risks assumed in a foreign country or countries.

Example 2. Space activity. (i) *Facts*. X is an Internet service provider. X offers a service that permits a customer (C) to connect to the Internet via a telephone call, initiated by the modem of C's personal computer, to a control center. X transmits information requested by C to C's personal computer, in part using satellite capacity leased by X from S. X performs the uplink and downlink functions. X charges its customers a flat monthly fee. Assume that neither X nor S derive international communications income within the meaning of §1.863–9(h)(3)(ii). In addition, assume that X is able to demonstrate, pursuant to paragraph (d)(2)(ii)(B) of this section, the extent to which the value of the service is attributable to functions performed, resources employed, and risks assumed in space.

(ii) *Analysis*. Under paragraph (d)(2)(ii) of this section, the service performed by X constitutes space activity to the extent the value of the service is attributable to functions performed, resources employed, and risks assumed in space. To the extent the service performed by X constitutes space activity, the source of X's income from the service transaction is determined under paragraph (b) of this section. To the extent the service performed by X does not constitute space or ocean activity, the source of X's income from the service is determined under sections 861, 862, and 863, as applicable. To the extent that X derives space and ocean income that is also communications income within the meaning of §1.863–9(h)(2), the source of X's income is determined under paragraph (b) of this section and §1.863–9(c), (d), and (f), as applicable, as provided in paragraph (b)(5) of this section. S derives space and ocean income that is also communications income within the meaning of §1.863–9(h)(2), and the source of S's income is therefore determined under paragraph (b) of this section and §1.863–9(c), (d), and (f), as applicable, as provided in paragraph (b)(5) of this section.

Example 3. Services as space activity—de minimis value attributable to performance occurring in space. (i) *Facts*. R owns a retail outlet in the United States. R engages S to provide a security system for R's premises. S operates its security system by transmitting images from R's premises directly to a satellite, and from the satellite to a group of S employees located in Country B, who monitor the premises by viewing the transmitted images. The satellite is used as a medium of delivery and not as a method of surveillance. O provides S with transponder capacity on O's satellite, which S uses to transmit those images. Assume that S's transaction with R

is characterized as the performance of a service. Assume that O's provision of transponder capacity is also viewed as the provision of a service. Assume also that S is able to demonstrate, pursuant to §1.863–9(h)(1), that the value of the transaction with R attributable to communications activities is de minimis.

(ii) *Analysis.* S derives income from providing monitoring services. S can demonstrate, pursuant to paragraph (d)(2)(ii) of this section, that based on all the facts and circumstances, the value of S's service transaction attributable to performance in space is de minimis. Thus, S is not treated as engaged in a space activity, and none of S's income from the service transaction is space income. In addition, because S demonstrates that the value of the transaction with R attributable to communications activities is de minimis, S is not required under §1.863–9(h)(1)(ii) to treat the transaction as separate communications and non-communications transactions, and none of S's gross income from the transaction is treated as communications income within the meaning of §1.863–9(h)(2). O's provision of transponder capacity is viewed as the provision of a service. Based on all the facts and circumstances, the value of O's service transaction attributable to performance in space is not de minimis. Thus, O's activity will be considered space activity, pursuant to paragraph (d)(2)(ii) of this section, to the extent the value of the services transaction is attributable to performance in space (unless O's activity in space is international communications activity). To the extent that O derives communications income, the source of such income is determined under paragraph (b) of this section and §1.863–9(b), (c), (d), and (f), as applicable, as provided in paragraph (b)(5) of this section. R does not derive any income from space activity.

Example 4. Space activity. (i) *Facts.* L, a domestic corporation, offers programming and certain other services to customers located both in the United States and in foreign countries. Assume that L's provision of programming and other services in this *Example 4* is characterized as the provision of a service, and that no part of the service transaction occurs in space or international water. Assume that the delivery of the programming constitutes a separate transaction also characterized as the performance of a service. L uses satellite capacity acquired from S to deliver the programming service directly to customers' television sets. L performs the uplink and downlink functions, so that part of the value of the delivery transaction derives from functions performed and resources employed in space. Assume that these contributions to the value of the delivery transaction occurring in space are not considered de minimis under paragraph (d)(2)(ii)(B) of this section. Customer C pays L to provide and deliver programming to C's residence in the United States. Assume S's provision of satellite capacity in this *Example 4* is viewed as the provision of a service, and also that S does not derive international communications income within the meaning of §1.863–9(h)(3)(ii).

(ii) *Analysis.* S's activity will be considered space activity. To the extent that S derives space and ocean income that is also communications income under §1.863–9(h)(2), the source of S's income is determined under paragraph (b) of this section and §1.863–9(c), (d), and (f), as applicable, as provided in paragraph (b)(5) of this section. On these facts, L's activities are treated as two separate service transactions: the provision of programming (and other services), and the delivery of programming. L's income derived from provision of programming and other services is not income derived from space activity. L's delivery of programming and other services is considered space activity, pursuant to paragraph (d)(2)(ii) of this section, to the extent the value of the delivery transaction is attributable to performance in space. To the extent that the delivery of programming is treated as a space activity, the source of L's income derived from the delivery transaction is determined under paragraph (b)(1) of this section, as provided in paragraph (b)(4) of this section. To the extent that L derives space and ocean income that is also communications income within the meaning of §1.863–9(h)(2), the source of such income is determined under paragraph (b) of this section and §1.863–9(b), (c), (d), (e), and (f), as applicable, as provided in paragraph (b)(5) of this section.

Example 5. Space activity. (i) *Facts.* The facts are the same as in *Example 4*, except that L does not deliver the programming service directly but instead engages R, a domestic corporation specializing in content delivery, to deliver by transmission its programming. For all portions of a transmission which require satellite capacity, R, in turn, contracts out such functions to S. S performs the uplink and downlink functions, so that part of the value of the delivery transaction derives from functions performed and resources employed in space.

(ii) *Analysis.* L's activity will not be considered space activity because none of L's activity occurs in space. Thus, L does not derive any space and ocean income. L does, however, derive communications income within the meaning of §1.863–9(h)(2). This is the case even though L does not perform the transmission function because L is paid by Customer C to transmit, and bears the risk of transmitting, the communications or data. To the extent that L's activity consists in part of non-de minimis communications and non-de minimis non-communications activity, each part of the transaction must be treated as a separate transaction and gross

income is allocated accordingly under §1.863–9(h)(1)(ii). In addition, L must also allocate expenses, losses, and other deductions, for example, payments to R, to the class or classes of gross income that include the income so allocated. R's activity will not be considered space activity. Since R contracts out all of the functions involving satellite capacity to S, no part of R's activity occurs in space. Thus, R does not derive any space and ocean income. R does, however, derive communications income within the meaning of §1.863–9(h)(2). This is the case even though R does not perform the transmission function because R is paid by L to transmit, and bears the risk of transmitting, the communications or data. S's activity will be considered space activity. To the extent that S derives space and ocean income that is also communications income within the meaning of §1.863–9(h)(2), the source of such income is determined under paragraph (b) of this section and §1.863–9(b), (c), (d), (e), and (f), as applicable, as provided in paragraph (b)(5) of this section.

Example 6. Space activity—treatment of land activity. (i) *Facts.* S, a United States person, offers remote imaging products and services to its customers. In year 1, S uses its satellite's remote sensors to gather data on certain geographical terrain. In year 3, C, a construction development company, contracts with S to obtain a satellite image of an area for site development work. S pulls data from its archives and transfers to C the images gathered in year 1, in a transaction that is characterized as a sale of the data. S's rights, title, and interest in the data pass to C in the United States. Before transferring the images to C, S uses computer software in its land-based office to enhance the images so that the images can be used.

(ii) *Analysis.* The collection of data and creation of images in space is characterized as the creation of property in space. Because S both produces and sells the data, S must allocate gross income from the sale of the data between production activity and sales activity under the 50/50 method of paragraph (b)(3)(ii)(A). The source of S's income allocable to production activity is determined under paragraph (b)(3)(ii)(C) of this section because production activities occur both in space and on land. The source of S's income attributable to sales activity is determined under paragraph (b)(3)(ii)(D) of this section (by reference to §1.863–3(c)(2)) as U.S. source income because S's rights, title, and interest in the data pass to C in the United States.

Example 7. Use of intangible property in space. (i) *Facts.* X acquires a license to use a particular satellite slot or orbit, which X sublicenses to C. C pays X a royalty.

(ii) *Analysis.* Because the royalty is paid for the right to use intangible property in space, the source of the royalty paid by C to X is determined under paragraph (b) of this section.

Example 8. Performance of services. (i) *Facts.* E, a domestic corporation, operates satellites with sensing equipment that can determine how much heat and light particular plants emit and reflect. Based on the data, E will provide F, a U.S. farmer, a report analyzing the data, which F will use in growing crops. E analyzes the data from offices located in the United States. Assume that E's combined activities are characterized as the performance of services.

(ii) *Analysis.* Based on all the facts and circumstances, the value of E's service transaction attributable to performance in space is not de minimis. Thus, E's activities will be considered space activities, pursuant to paragraph (d)(2)(ii) of this section, to the extent the value of E's service transaction is attributable to performance in space. To the extent E's service transaction constitutes a space activity, the source of E's income derived from the service transaction will be determined under paragraph (b)(4) of this section, by reference to paragraph (b)(1) of this section. To the extent that E's service transaction does not constitute a space or ocean activity, the source of E's income derived from the service transaction is determined under sections 861, 862, and 863, as applicable.

Example 9. Separate transactions. (i) Facts. The same facts as *Example 8*, except that E provides the raw data to F in a transaction characterized as a sale of a copyrighted article. In addition, E provides an analysis in the form of a report to F. The price F pays E for the raw data is separately stated.

(ii) *Analysis.* To the extent that the provision of raw data and the analysis of the data are each treated as separate transactions, the source of income from the production and sale of data is determined under paragraph (b)(3)(ii) of this section. The provision of services would be analyzed in the same manner as in *Example 8*.

Example 10. Sale of property in international water. (i) *Facts.* T purchased and owns transatlantic cable that lies in international water. T sells the cable to B, with T's rights, title, and interest in the cable passing to B in international water. Assume that the transatlantic cable is not inventory property within the meaning of section 1221(a)(1).

(ii) *Analysis.* Because T's rights, title, and interest in the property pass to B in international water, the sale takes place in international water under §1.861–7(c), and the sale transaction is ocean activity under paragraph (d)(1)(ii) of this section. The source of T's sales income is determined under paragraph (b)(3)(i) of this section, by reference to paragraph (b)(1) or (2) of this section.

Example 11. Sale of property in space. (i) *Facts.* S, a United States person, manufactures a satellite in the United States and sells it to a customer who is not a United

States person. S's rights, title, and interest in the satellite pass to the customer in space.

(ii) *Analysis.* Because S's rights, title, and interest in the satellite pass to the customer in space, the sale takes place in space under §1.861–7(c), and the sale transaction is space activity under paragraph (d)(1)(i) of this section. The source of income derived from the sale of the satellite in space is determined under paragraph (b)(3)(ii) of this section, with the source of income allocable to production activity determined under paragraphs (b)(3)(ii)(A) and (B) of this section, and the source of income allocable to sales activity determined under paragraphs (b)(3)(ii)(A) and (D) of this section. Under paragraph (b)(1) of this section, S's space income is sourced outside the United States to the extent the income, based on all the facts and circumstances, is attributable to functions performed, resources employed, or risks assumed in a foreign country or countries.

Example 12. Sale of property in space. (i) *Facts.* S has a right to operate from a particular position (satellite slot or orbit) in space. S sells the right to operate from that position to P. Assume that the sale of the satellite slot is characterized as a sale of property and that S's rights, title, and interest in the satellite slot pass to P in space.

(ii) *Analysis.* The sale of the satellite slot takes place in space under §1.861–7(c) because S's rights, title, and interest in the satellite slot pass to P in space. The sale of the satellite slot is space activity under paragraph (d)(1)(i) of this section, and income or gain from the sale is sourced under paragraph (b)(3)(i) of this section, by reference to paragraph (b)(1) or (2) of this section.

Example 13. Source of income of a foreign person. (i) *Facts.* FP, a foreign corporation that is not a CFC, derives income from the operation of satellites. FP operates ground stations in the United States and in foreign Country FC. Assume that FP is considered engaged in a trade or business within the United States based on FP's operation of the ground station in the United States.

(ii) *Analysis.* Under paragraph (b)(2)(iii) of this section, FP's space income is sourced in the United States to the extent the income, based on all the facts and circumstances, is attributable to functions performed, resources employed, or risks assumed within the United States.

Example 14. Source of income of a foreign person. (i) *Facts.* FP, a foreign corporation that is not a CFC, operates remote sensing satellites in space to collect data and images for its customers. FP uses an independent agent, A, in the United States who provides marketing, order-taking, and other customer service functions. Assume that FP is considered engaged in a trade or business within the United States based on A's activities on FP's behalf in the United States.

(ii) *Analysis.* Under paragraph (b)(2)(iii) of this section, FP's space income is sourced in the United States to the extent the income, based on all the facts and circumstances, is attributable to functions performed, resources employed, or risks assumed within the United States.

(g) *Reporting and documentation requirements*—(1) *In general.* A taxpayer making an allocation of gross income under paragraph (b)(1), (b)(2), (b)(3)(ii)(C), or (b)(4) of this section must satisfy the requirements in paragraphs (g)(2), (3), and (4) of this section.

(2) *Required documentation.* In all cases, a taxpayer must prepare and maintain documentation in existence when its return is filed regarding the allocation of gross income and allocation and apportionment of expenses, losses, and other deductions, the methodologies used, and the circumstances justifying use of those methodologies. The taxpayer must make available such documentation within 30 days upon request.

(3) *Access to software.* If the taxpayer or any third party used any computer software, within the meaning of section 7612(d), to allocate gross income, or to allocate or apportion expenses, losses, and other deductions, the taxpayer must make available upon request—

(i) Any computer software executable code, within the meaning of section 7612(d), used for such purposes, including an executable copy of the version of the software used in the preparation of the taxpayer's return (including any plug-ins, supplements, etc.) and a copy of all related electronic data files. Thus, if software subsequently is upgraded or supplemented, a separate executable copy of the version used in preparing the taxpayer's return must be retained;

(ii) Any related computer software source code, within the meaning of section 7612(d), acquired or developed by the taxpayer or a related person, or primarily for internal use by the taxpayer or such person rather than for commercial distribution; and

(iii) In the case of any spreadsheet software or similar software, any formulae or links to supporting worksheets.

(4) *Use of allocation methodology*. In general, when a taxpayer allocates gross income under paragraph (b)(1), (b)(2), (b)(3)(ii)(C), or (b)(4) of this section, it does so by making the allocation on a timely filed original return (including extensions). However, a taxpayer will be permitted to make changes to such allocations made on its original return with respect to any taxable year for which the statute of limitations has not closed as follows:

(i) In the case of a taxpayer that has made a change to such allocations prior to the opening conference for the audit of the taxable year to which the allocation relates or who makes such a change within 90 days of such opening conference, if the IRS issues a written information document request asking the taxpayer to provide the documents and such other information described in paragraphs (g)(2) and (3) of this section with respect to the changed allocations and the taxpayer complies with such request within 30 days of the request, then the IRS will complete its examination, if any, with respect to the allocations for that year as part of the current examination cycle. If the taxpayer does not provide the documents and information described in paragraphs (g)(2) and (3) of this section within 30 days of the request, then the procedures described in paragraph (g)(4)(ii) of this section shall apply.

(ii) If the taxpayer changes such allocations more than 90 days after the opening conference for the audit of the taxable year to which the allocations relate or the taxpayer does not provide the documents and information with respect to the changed allocations as requested in accordance with paragraphs (g)(2) and (3) of this section, then the IRS will, in a separate cycle, determine whether an examination of the taxpayer's allocations is warranted and complete any such examination. The separate cycle will be worked as resources are available and may not have the same estimated completion date as the other issues under examination for the taxable year. The IRS may ask the taxpayer to extend the statute of limitations on assessment and collection for the taxable year to permit examination of the taxpayer's method of allocation, including an extension limited, where appropriate, to the taxpayer's method of allocation.

(h) *Effective date*. This section applies to taxable years beginning on or after December 27, 2006.

[T.D. 9305, 71 FR 77603, Dec. 27, 2006]

§ 1.863–9 Source of income derived from communications activity under section 863(a), (d), and (e).

(a) *In general*. Income of a United States or a foreign person derived from each type of communications activity, as defined in paragraph (h)(3) of this section, is sourced under the rules of this section, notwithstanding any other provision including sections 861, 862, 863, and 865. Notwithstanding that a communications activity would qualify as space or ocean activity under section 863(d) and the regulations thereunder, the source of income derived from such communications activity is determined under this section, and not under section 863(d) and the regulations thereunder, except to the extent provided in § 1.863–8(b)(5).

(b) *Source of international communications income—(1) International communications income derived by a United States person*. Income derived from international communications activity (international communications income) by a United States person is one-half from sources within the United States and one-half from sources without the United States.

(2) *International communications income derived by foreign persons*—(i) *In general*. International communications income derived by a person other than a United States person is, except as otherwise provided in this paragraph (b)(2), wholly from sources without the United States.

(ii) *International communications income derived by a controlled foreign corporation*. International communications income derived by a controlled foreign corporation within the meaning of section 957 (CFC) is one-half from sources within the United States and one-half from sources without the United States.

(iii) *International communications income derived by foreign persons with a fixed place of business in the United States*. International communications income derived by a foreign person,

other than a CFC, that is attributable to an office or other fixed place of business of the foreign person in the United States is from sources within the United States. The principles of section 864(c)(5) apply in determining whether a foreign person has an office or fixed place of business in the United States. See §1.864–7. International communications income is attributable to an office or other fixed place of business to the extent of functions performed, resources employed, or risks assumed by the office or other fixed place of business.

(iv) *International communications income derived by foreign persons engaged in a trade or business within the United States.* International communications income derived by a foreign person (other than a CFC) engaged in a trade or business within the United States is income from sources within the United States to the extent the income, based on all the facts and circumstances, is attributable to functions performed, resources employed, or risks assumed within the United States.

(c) *Source of U.S. communications income.* Income derived by a United States or foreign person from U.S. communications activity is from sources within the United States.

(d) *Source of foreign communications income.* Income derived by a United States or foreign person from foreign communications activity is from sources without the United States.

(e) *Source of space/ocean communications income.* The source of income derived by a United States or foreign person from space/ocean communications activity is determined under section 863(d) and the regulations thereunder.

(f) *Source of communications income when taxpayer cannot establish the two points between which the taxpayer is paid to transmit the communication.* Income derived by a United States or foreign person from communications activity, when the taxpayer cannot establish the two points between which the taxpayer is paid to transmit the communication as required in paragraph (h)(3)(i) of this section, is from sources within the United States.

(g) *Taxable income.* When a taxpayer allocates gross income under paragraph (b)(2)(iii), (b)(2)(iv), or (h)(1)(ii) of this section, the taxpayer must allocate expenses, losses, and other deductions as prescribed in §§1.861–8 through 1.861–14T to the class or classes of gross income that include the income so allocated in each case. A taxpayer must then apply the rules of §§1.861–8 through 1.861–14T properly to apportion amounts of expenses, losses, and other deductions so allocated to such gross income between gross income from sources within the United States and gross income from sources without the United States. For amounts of expenses, losses, and other deductions allocated to gross income derived from international communications activity, when the source of income is determined under the 50/50 method of paragraph (b)(1) or (b)(2)(ii) of this section, taxpayers generally must apportion expenses, losses, and other deductions between sources within the United States and sources without the United States pro rata based on the relative amounts of gross income from sources within the United States and gross income from sources without the United States. However, the preceding sentence shall not apply to research and experimental expenditures qualifying under §1.861–17, which are to be allocated and apportioned under the rules of that section.

(h) *Communications activity and income derived from communications activity*—(1) *Communications activity*—(i) *General rule.* For purposes of this part, *communications activity* consists solely of the delivery by transmission of communications or data (communications). Delivery of communications other than by transmission (for example, by delivery of physical packages and letters) is not communications activity within the meaning of this section. Communications activity also includes the provision of capacity to transmit communications. Provision of content or any other additional service provided along with, or in connection with, a non-de minimis communications activity must be treated as a separate non-communications activity unless de minimis. Communications activity or non-communications activity will be treated as de minimis to the extent, based on the facts and circumstances,

the value attributable to such activity is de minimis.

(ii) *Separate transaction*. To the extent that a taxpayer's transaction consists in part of non-de minimis communications activity and in part of non-de minimis non-communications activity, each such part of the transaction must be treated as a separate transaction. Gross income is allocated to each such communications activity transaction and non-communications activity transaction to the extent the income, based on all the facts and circumstances, is attributable to functions performed, resources employed, or risks assumed in each such activity.

(2) *Income derived from communications activity*. *Income derived from communications activity* (communications income) is income derived from the delivery by transmission of communications, including income derived from the provision of capacity to transmit communications. Income may be considered derived from a communications activity even if the taxpayer itself does not perform the transmission function, but in all cases, the taxpayer derives communications income only if the taxpayer is paid to transmit, and bears the risk of transmitting, the communications.

(3) *Determining the type of communications activity*—(i) *In general*. Whether income is derived from international communications activity, U.S. communications activity, foreign communications activity, or space/ocean communications activity is determined by identifying the two points between which the taxpayer is paid to transmit the communication. The taxpayer must establish the two points between which the taxpayer is paid to transmit, and bears the risk of transmitting, the communication. Whether the taxpayer contracts out part or all of the transmission function is not relevant. A taxpayer may satisfy the requirement that the taxpayer establish the two points between which the taxpayer is paid to transmit, and bears the risk of transmitting, the communication by using any consistently applied reasonable method to establish one or both endpoints. In evaluating the reasonableness of such method, consideration will be given to all the facts and circumstances, including whether the endpoints would otherwise be identifiable absent this reasonable method provision and the reliability of the data. Depending on the facts and circumstances, methods based on, for example, records of port or transport charges, customer billing records, a satellite footprint, or records of termination fees made pursuant to an international settlement agreement may be reasonable. In addition, practices used by taxpayers to classify or categorize certain communications activity in connection with preparation of statements and analyses for the use of management, creditors, minority shareholders, joint ventures, or other parties or governmental agencies in interest may be reliable indicators of the reasonableness of the method chosen, but need not be accorded conclusive weight by the Commissioner. In all cases, the method chosen to establish the two points between which the taxpayer is paid to transmit, and bears the risk of transmitting, the communication must be supported by sufficient documentation to permit verification by the Commissioner.

(ii) *Income derived from international communications activity*. *Income derived by a taxpayer from international communications activity* (international communications income) is income derived from communications activity, as defined in paragraph (h)(2) of this section, when the taxpayer is paid to transmit—

(A) Between a point in the United States and a point in a foreign country (or a possession of the United States); or

(B) Foreign-originating communications (communications with a beginning point in a foreign country or a possession of the United States) from a point in space or international water to a point in the United States.

(iii) *Income derived from U.S. communications activity*. Income derived by a taxpayer from U.S. communications activity (U.S. communications income) is income derived from communications activity, as defined in paragraph (h)(2) of this section, when the taxpayer is paid to transmit—

(A) Between two points in the United States; or

(B) Between the United States and a point in space or international water, except as provided in paragraph (h)(3)(ii)(B) of this section.

(iv) *Income derived from foreign communications activity. Income derived by a taxpayer from foreign communications activity* (foreign communications income) is income derived from communications activity, as defined in paragraph (h)(2) of this section, when the taxpayer is paid to transmit—

(A) Between two points in a foreign country or countries (or a possession or possessions of the United States);

(B) Between a foreign country and a possession of the United States; or

(C) Between a foreign country (or a possession of the United States) and a point in space or international water.

(v) *Income derived from space/ocean communications activity. Income derived by a taxpayer from space/ocean communications activity* (space/ocean communications income) is income derived from communications activity, as defined in paragraph (h)(2) of this section, when the taxpayer is paid to transmit between a point in space or international water and another point in space or international water.

(i) *Treatment of partnerships.* This section is applied at the partner level.

(j) *Examples.* The following examples illustrate the rules of this section:

Example 1. Income derived from non-communications activity—remote data base access. (i) *Facts.* D provides its customers in various foreign countries with access to its data base, which contains information on certain individuals' health care insurance coverage. Customer C obtains access to D's data base by placing a call to D's telephone number. Assume that C's telephone service, used to access D's data base, is provided by a third party, and that D assumes no responsibility for the transmission of the information via telephone.

(ii) *Analysis.* D is not paid to transmit communications and does not derive income from communications activity within the meaning of paragraph (h)(2) of this section. Rather, D derives income from provision of content or provision of services to its customers. Therefore, the rules of this section do not apply to determine the source of D's income.

Example 2. Income derived from U.S. communications activity—U.S. portion of international communication. (i) *Facts.* TC, a local telephone company, receives an access fee from an international carrier for picking up a call from a local telephone customer and delivering the call to a U.S. point of presence (POP) of the international carrier. The international carrier picks up the call from its U.S. POP and delivers the call to a foreign country.

(ii) *Analysis.* TC is not paid to carry the transmission between the United States and a foreign country. TC is paid to transmit a communication between two points in the United States. TC derives U.S. communications income as defined in paragraph (h)(3)(iii) of this section, which is sourced under paragraph (c) of this section as U.S. source income.

Example 3. Income derived from international communications activity—underwater cable. (i) *Facts.* TC, a domestic corporation, owns an underwater fiber optic cable. Pursuant to contracts, TC makes available to its customers capacity to transmit communications via the cable. TC's customers then solicit telephone customers and arrange to transmit the telephone customers' calls. The cable runs in part through U.S. waters, in part through international waters, and in part through foreign country waters.

(ii) Analysis. TC derives international communications income as defined in paragraph (h)(3)(ii) of this section because TC is paid to make available capacity to transmit communications between the United States and a foreign country. Because TC is a United States person, TC's international communications income is sourced under paragraph (b)(1) of this section as one-half from sources within the United States and one-half from sources without the United States.

Example 4. Income derived from international communications activity—satellite. (i) *Facts.* S, a United States person, owns satellites in orbit and uplink facilities in Country X, a foreign country. B, a resident of Country X, pays S to deliver B's programming from S's uplink facility, located in Country X, to a downlink facility in the United States owned by C, a customer of B.

(ii) *Analysis.* S derives international communications income under paragraph (h)(3)(ii) of this section because S is paid to transmit the communications between a beginning point in a foreign country and an endpoint in the United States. Because S is a United States person, the source of S's international communications income is determined under paragraph (b)(1) of this section as one-half from sources within the United States and one-half from sources without the United States.

Example 5. The paid-to-do rule—foreign communications via domestic route. (i) *Facts.* TC is paid to transmit communications from Toronto, Canada, to Paris, France. TC transmits the communications from Toronto to New York. TC pays another communications

company, IC, to transmit the communications from New York to Paris.

(ii) *Analysis.* Under the *paid-to-do* rule of paragraph (h)(3)(i) of this section, TC derives foreign communications income under paragraph (h)(3)(iv) of this section because TC is paid to transmit communications between two points in foreign countries, Toronto and Paris. Under paragraph (h)(3)(i) of this section, the character of TC's communications activity is determined without regard to the fact that TC pays IC to transmit the communications for some portion of the delivery path. IC has international communications income under paragraph (h)(3)(ii) of this section because IC is paid to transmit the communications between a point in the United States and a point in a foreign country.

Example 6. The paid-to-do rule—domestic communication via foreign route. (i) *Facts.* TC is paid to transmit a call between two points in the United States, but routes the call through Canada.

(ii) *Analysis.* Under paragraph (h)(3)(i) of this section, the character of income derived from communications activity is determined by the two points between which the taxpayer is paid to transmit, and bears the risk of transmitting, the communications, without regard to the path of the transmission between those two points. Thus, under paragraph (h)(3)(iii) of this section, TC derives income from U.S. communications activity because it is paid to transmit the communications between two U.S. points.

Example 7. The paid-to-do rule—foreign-originating communications. (i) *Facts.* Under an international settlement agreement, G, a Country X international carrier, pays T to receive all calls originating in Country X that are bound for the United States and to terminate such calls in the United States. Due to Country X legal restrictions, the international settlement agreement specifies that G carries the transmission to a point outside the territory of Country X and that T carries the foreign-originating transmission from such point to the destined point in the United States. T, in turn, contracts out with another communications company, S, to transmit the U.S. portion of the communications. Tracing and identifying the endpoints of each transmission is not possible or practical. T does, however, keep records of termination fees received from G for terminating the foreign-originating calls.

(ii) *Analysis.* T derives communications income as defined in paragraph (h)(2) of this section. Based on all the facts and circumstances, T can establish that T is paid to transmit, and bears the risk of transmitting, foreign-originating calls from a point in space or international water to a point in the United States using a reasonable method to establish the endpoints, assuming that this method is consistently applied. In this case, T can reasonably establish that T is paid to receive foreign-originating calls and terminate such calls in the United States based on the records of termination fees pursuant to an international settlement agreement. Under paragraph (h)(3)(ii)(B) of this section, a taxpayer derives income from international communications activity when the taxpayer is paid to transmit foreign-originating communications from space or international water to the United States. Thus, under paragraph (h)(3)(ii)(B) of this section, T derives income from international communications. If, based on all the facts and circumstances, T could reasonably trace and identify the endpoints, then T would have to directly establish that each call originated in a foreign country. Assuming T is able to do so, the rest of the analysis in this *Example 7* remains the same. Under paragraph (h)(3)(iii) of this section, S derives income from U.S. communications activity because S is paid to transmit the communications between two U.S. points.

Example 8. Indeterminate endpoints—prepaid telephone calling cards. (i) *Facts.* S purchases capacity from TC to transmit telephone calls. S sells prepaid telephone calling cards that give customers access to TC's telephone lines for a certain number of minutes. Assume that S cannot establish the endpoints of its customers' telephone calls, even under the reasonable method rule of paragraph (h)(3) of this section.

(ii) *Analysis.* S derives communications income as defined in paragraph (h)(2) of this section because S makes capacity to transmit communications available to its customers. In this case, S cannot establish the two points between which the communications are transmitted. Therefore, S's communications income is U.S. source income, as provided by paragraph (f) of this section.

Example 9. Reasonable methods—minutes of use data on long distance calling plans. (i)*Facts.* B provides both domestic and international long distance services in a calling plan for a limited number of minutes for a set amount each month. Tracing and identifying the endpoints of each transmission is not possible or practical. B is, however, able to establish that the calling plan generated $10,000 of revenue for 25,000 minutes based on reports derived from customer billing records. Based on minutes of use data in these reports, B is able to establish that of the total 25,000 minutes, 60 percent or 15,000 minutes were for U.S. long distance calls and 40 percent or 10,000 minutes were for international calls.

(ii) *Analysis.* B derives communications income as defined in paragraph (h)(2) of this section. Based on all the facts and circumstances, B can establish the two points between which B is paid to transmit, and

bears the risk of transmitting, the communications using a reasonable method to establish the endpoints, assuming that this method is consistently applied. In this case, B can reasonably establish that 60 percent of the income derived from the long distance calling plan is U.S. communications income and 40 percent is international communications income based on the minutes of use data derived from customer billing records to establish the endpoints of the communications. If, based on all the facts and circumstances, B could reasonably trace and identify the endpoints, then B would have to directly identify the endpoints between which B is paid to transmit the communications.

Example 10. Reasonable methods—system design. (i) *Facts.* D operates satellites which are designed to transmit signals through two separate ranges of signal frequencies (bands). Due to technological limitations, requirements, and practicalities, one band is designed to only transmit signals within the United States. The other band is designed to transmit signals between foreign countries and the United States. D cannot trace and identify the endpoints of each individual transmission. D does, however, track the total transmission through each band and the total income derived from transmitting signals through each band.

(ii) *Analysis.* D derives communications income as defined in paragraph (h)(2) of this section. Based on all the facts and circumstances, D can establish the two points between which D is paid to transmit, and bears the risk of transmitting, the communications using a reasonable method to establish endpoints, assuming that this method is consistently applied. In this case, D can reasonably establish that income derived from transmissions through the first band is U.S. communications income and income derived from transmissions through the second band is international communications income based on the design of the bands to establish the endpoints of the communications.

Example 11. Reasonable methods—port locations. (i) *Facts.* X provides its customer, C, with a virtual private network (VPN) so that C's U.S. headquarter office can connect and communicate with offices in the United States, Country X, Country Y, and Country Z. Assume that the VPN is only for communications with the U.S. headquarter office. X cannot trace and identify the endpoints of each transmission. C pays X a set amount each month for the entire service, regardless of the magnitude of the usage or the geographic points between which C uses the service.

(ii) *Analysis.* X derives communications income as defined in paragraph (h)(2) of this section. Based on the facts and circumstances, X can establish the two points between which X is paid to transmit, and bears the risk of transmitting, the communications using a reasonable method to establish endpoints, assuming that this method is consistently applied. In this case, X can reasonably establish that one-fourth of the income derived from the VPN service is U.S. communications income and three-fourths is international communications income based on the location of the VPN ports to establish the endpoints of the communications.

Example 12. Indeterminate endpoints—Internet access. (i) *Facts.* B, a domestic corporation, is an Internet service provider. B charges its customer, C, a monthly lump sum for Internet access. C accesses the Internet via a telephone call, initiated by the modem of C's personal computer, to one of B's control centers, which serves as C's portal to the Internet. B transmits data sent by C from B's control center in France to a recipient in England, over the Internet. B does not maintain records as to the beginning and endpoints of the transmission.

(ii) *Analysis.* B derives communications income as defined in paragraph (h)(2) of this section. The source of B's communications income is determined under paragraph (f) of this section as income from sources within the United States because B cannot establish the two points between which it is paid to transmit the communications.

Example 13. De minimis non-communications activity. (i) *Facts.* The same facts as in Example 12.

Assume in addition that B replicates frequently requested sites on B's own servers, solely to speed up response time. Assume that B's replication of frequently requested sites would be considered a de minimis non-communications activity under this section.

(ii) *Analysis.* On these facts, because B's replication of frequently requested sites would be considered a *de minimis* non-communications activity, B is not required to treat the replication activity as a separate non-communications activity transaction under paragraph (h)(1) of this section. B derives communications income under paragraph (h)(2) of this section. The character and source of B's communications income are determined by demonstrating the points between which B is paid to transmit the communications, under paragraph (h)(3)(i) of this section.

Example 14. Income derived from communications and non-communications activity—bundled services. (i) *Facts.* A, a domestic corporation, offers customers local and long distance phone service, video, and Internet services. Customers pay a flat monthly fee plus 10 cents a minute for all long-distance calls, including international calls.

(ii) *Analysis.* Under paragraph (h)(1)(ii) of this section, to the extent that A's transaction with its customer consists in part of non-de minimis communications activity

and in part of non-de minimis non-communications activity, each such part of the transaction must be treated as a separate transaction. A's gross income from the transaction is allocated to each such communications activity transaction and non-communications activity transaction in accordance with paragraph (h)(1)(ii) of this section. To the extent A can establish that it derives international communications income as defined in paragraph (h)(3)(ii) of this section, A would determine the source of such income under paragraph (b)(1) of this section. If A cannot establish the points between which it is paid to transmit communications, as required by paragraph (h)(3)(i) of this section, A's communications income is from sources within the United States, as provided by paragraph (f) of this section.

Example 15. Income derived from communications and non-communications activity. (i) *Facts.* B, a domestic corporation, is paid by D, a cable system operator in Foreign Country, to provide television programs and to transmit the television programs to Foreign Country. Using its own satellite transponder, B transmits the television programs from the United States to downlink facilities owned by D in Foreign Country. D receives the transmission, unscrambles the signals, and distributes the broadcast to D's customers in Foreign Country. Assume that B's provision of television programs is a non-de minimis non-communications activity, and that B's transmission of television programs is a non-de minimis communications activity.

(ii) *Analysis.* Under paragraph (h)(1)(ii) of this section, B must treat its communications and non-communications activities as separate transactions. B's gross income is allocated to each such separate communications and non-communications activity transaction in accordance with paragraph (h)(1)(ii) of this section. Income derived by B from the transmission of television programs to D's Foreign Country downlink facility is international communications income as defined in paragraph (h)(3)(ii) of this section because B is paid to transmit communications from the United States to a foreign country.

Example 16. Income derived from foreign communications activity. (i) *Facts.* STS provides satellite capacity to B, a broadcaster located in Australia. B beams programming from Australia to the satellite. S's satellite picks the communications up in space and beams the programming over a footprint covering Southeast Asia.

(ii) *Analysis.* S derives communications income as defined in paragraph (h)(2) of this section. S's income is characterized as foreign communications income under paragraph (h)(3)(iv) of this section because S picks up the communication in space, and beams it to a footprint entirely covering a foreign area. Under paragraph (d) of this section, S's foreign communications income is from sources without the United States. If S were beaming the programming over a satellite footprint that covered area both in the United States and outside the United States, S would be required to allocate the income derived from the different types of communications activity.

(k) *Reporting and documentation requirements*—(1) *In general.* A taxpayer making an allocation of gross income under paragraph (b)(2)(iii), (b)(2)(iv), or (h)(1)(ii) of this section must satisfy the requirements in paragraphs (k)(2), (3), and (4) of this section.

(2) *Required documentation.* In all cases, a taxpayer must prepare and maintain documentation in existence when its return is filed regarding the allocation of gross income, and allocation and apportionment of expenses, losses, and other deductions, the methodologies used, and the circumstances justifying use of those methodologies. The taxpayer must make available such documentation within 30 days upon request.

(3) *Access to software.* If the taxpayer or any third party used any computer software, within the meaning of section 7612(d), to allocate gross income, or to allocate or apportion expenses, losses, and other deductions, the taxpayer must make available upon request—

(i) Any computer software executable code, within the meaning of section 7612(d), used for such purposes, including an executable copy of the version of the software used in the preparation of the taxpayer's return (including any plug-ins, supplements, etc.) and a copy of all related electronic data files. Thus, if software subsequently is upgraded or supplemented, a separate executable copy of the version used in preparing the taxpayer's return must be retained;

(ii) Any related computer software source code, within the meaning of section 7612(d), acquired or developed by the taxpayer or a related person, or primarily for internal use by the taxpayer or such person rather than for commercial distribution; and

(iii) In the case of any spreadsheet software or similar software, any formulae or links to supporting worksheets.

(4) *Use of allocation methodology*. In general, when a taxpayer allocates gross income under paragraph (b)(2)(iii), (b)(2)(iv), or (h)(1)(ii) of this section, it does so by making the allocation on a timely filed original return (including extensions). However, a taxpayer will be permitted to make changes to such allocations made on its original return with respect to any taxable year for which the statute of limitations has not closed as follows:

(i) In the case of a taxpayer that has made a change to such allocations prior to the opening conference for the audit of the taxable year to which the allocation relates or who makes such a change within 90 days of such opening conference, if the IRS issues a written information document request asking the taxpayer to provide the documents and such other information described in paragraphs (k)(2) and (3) of this section with respect to the changed allocations and the taxpayer complies with such request within 30 days of the request, then the IRS will complete its examination, if any, with respect to the allocations for that year as part of the current examination cycle. If the taxpayer does not provide the documents and information described in paragraphs (k)(2) and (3) of this section within 30 days of the request, then the procedures described in paragraph (k)(4)(ii) of this section shall apply.

(ii) If the taxpayer changes such allocations more than 90 days after the opening conference for the audit of the taxable year to which the allocations relate or the taxpayer does not provide the documents and information with respect to the changed allocations as requested in accordance with paragraphs (k)(2) and (3) of this section, then the IRS will, in a separate cycle, determine whether an examination of the taxpayer's allocations is warranted and complete any such examination. The separate cycle will be worked as resources are available and may not have the same estimated completion date as the other issues under examination for the taxable year. The IRS may ask the taxpayer to extend the statute of limitations on assessment and collection for the taxable year to permit examination of the taxpayer's method of allocation, including an extension limited, where appropriate, to the taxpayer's method of allocation.

(l) *Effective date*. This section applies to taxable years beginning on or after December 27, 2006.

[T.D. 9305, 71 FR 77603, Dec. 27, 2006; 72 FR 3490, Jan. 25, 2007]

§ 1.863–10 Source of income from a qualified fails charge.

(a) *In general*. Except as provided in paragraphs (b) and (c) of this section, the source of income from a qualified fails charge shall be determined by reference to the residence of the taxpayer as determined under section 988(a)(3)(B)(i).

(b) *Qualified business unit exception*. The source of income from a qualified fails charge shall be determined by reference to the residence of a qualified business unit (as defined in section 989) of a taxpayer if—

(1) The taxpayer's residence, determined under section 988(a)(3)(B)(i), is the United States;

(2) The qualified business unit's residence, determined under section 988(a)(3)(B)(ii), is outside the United States;

(3) The qualified business unit is engaged in the conduct of a trade or business in the country where it is a resident; and

(4) The transaction to which the qualified fails charge relates is attributable to the qualified business unit. A transaction will be treated as attributable to a qualified business unit if it satisfies the principles of § 1.864–4(c)(5)(iii) (substituting ''qualified business unit'' for ''U.S. office'').

(c) *Effectively connected income exception*. Qualified fails charge income that arises from a transaction any income from which is (or would be if the transaction produced income) effectively connected with a United States trade or business pursuant to § 1.864–4(c) is treated as from sources within the United States, and the income from the qualified fails charge is treated as effectively connected to the conduct of a United States trade or business.

(d) *Qualified fails charge*. For purposes of this section, a qualified fails charge is a payment that—

(1) Compensates a party to a transaction that provides for delivery of a

designated security (as defined in paragraph (e) of this section) in exchange for the payment of cash (delivery-versus-payment settlement) for another party's failure to deliver the specified designated security on the settlement date specified in the relevant agreement; and

(2) Is made pursuant to—

(i) A trading practice or similar guidance approved or adopted by either an agency of the United States government or the Treasury Market Practices Group, or

(ii) Any trading practice, program, policy or procedure approved by the Commissioner in guidance published in the Internal Revenue Bulletin.

(e) *Designated security*. For purposes of this section, a *designated security* means any—

(i) Debt instrument (as defined in §1.1275–1(d)) issued by the United States Treasury Department, the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, or any Federal Home Loan Bank; or

(ii) Pass-through mortgage-backed security guaranteed by the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, or the Government National Mortgage Association.

(g) *Effective/applicability date*. This section is effective on February 21, 2012. This section applies to a qualified fails charge paid or accrued on or after December 8, 2010.

[T.D. 9579, 77 FR 9847, Feb. 21, 2012]

§ 1.864–1 Meaning of sale, etc.

For purposes of §§1.861 through 1.864–7, the word ''sale'' includes ''exchange''; the word ''sold'' includes ''exchanged''; the word ''produced'' includes ''created'', ''fabricated'', ''manufactured'', ''extracted'', ''processed'', ''cured'', and ''aged''.

[T.D. 6948, 33 FR 5090, Mar. 28, 1968]

§ 1.864–2 Trade or business within the United States.

(a) *In general*. As used in part I (section 861 and following) and part II (section 871 and following), subchapter N, chapter 1 of the Code, and chapter 3 (section 1441 and following) of the Code, and the regulations thereunder, the term ''engaged in trade or business within the United States'' does not include the activities described in paragraphs (c) and (d) of this section, but includes the performance of personal services within the United States at any time within the taxable year except to the extent otherwise provided in this section.

(b) *Performance of personal services for foreign employer*—(1) *Excepted services*. For purposes of paragraph (a) of this section, the term ''engaged in trade or business within the United States'' does not include the performance of personal services—

(i) For a nonresident alien individual, foreign partnership, or foreign corporation, not engaged in trade or business within the United States at any time during the taxable year, or

(ii) For an office or place of business maintained in a foreign country or in a possession of the United States by an individual who is a citizen or resident of the United States or by a domestic partnership or a domestic corporation, by a nonresident alien individual who is temporarily present in the United States for a period or periods not exceeding a total of 90 days during the taxable year and whose compensation for such services does not exceed in the aggregate gross amount of $3,000.

(2) *Rules of application*. (i) As a general rule, the term ''day'', as used in subparagraph (1) of this paragraph, means a calendar day during any portion of which the nonresident alien individual is physically present in the United States.

(ii) Solely for purposes of applying this paragraph, the nonresident alien individual, foreign partnership, or foreign corporation for which the nonresident alien individual is performing personal services in the United States shall not be considered to be engaged in trade or business in the United States by reason of the performance of such services by such individual.

(iii) In applying subparagraph (1) of this paragraph it is immaterial whether the services performed by the nonresident alien individual are performed as an employee for his employer or under any form of contract with the

person for whom the services are performed.

(iv) In determining for purposes of subparagraph (1) of this paragraph whether compensation received by the nonresident alien individual exceeds in the aggregate a gross amount of $3,000, any amounts received by the individual from an employer as advances or reimbursements for travel expenses incurred on behalf of the employer shall be omitted from the compensation received by the individual, to the extent of expenses incurred, where he was required to account and did account to his employer for such expenses and has met the tests for such accounting provided in § 1.162–17 and paragraph (e)(4) of § 1.274–5. If advances or reimbursements exceed such expenses, the amount of the excess shall be included as compensation for personal services for purposes of such subparagraph. Pensions and retirement pay attributable to personal services performed in the United States are not to be taken into account for purposes of subparagraph (1) of this paragraph.

(v) See section 7701(a)(5) and § 301.7701–5 of this chapter (Procedure and Administration Regulations) for the meaning of ''foreign'' when applied to a corporation or partnership.

(vi) As to the source of compensation for personal services, see §§ 1.861–4 and 1.862–1.

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

Example 1. During 1967, A, a nonresident alien individual, is employed by the London office of a domestic partnership. A, who uses the calendar year as his taxable year, is temporarily present in the United States during 1967 for 60 days performing personal service in the United States for the London office of the partnership and is paid by that office a total gross salary of $2,600 for such services. During 1967, A is not engaged in trade or business in the United States solely by reason of his performing such personal services for the London office of the domestic partnership.

Example 2. The facts are the same as in example 1, except that A's total gross salary for the services performed in the United States during 1967 amounts to $3,500, of which $2,625 is received in 1967 and $875 is received in 1968. During 1967, is engaged in trade or business in the United States by reason of his performance of personal services in the United States.

(c) *Trading in stocks or securities*. For purposes of paragraph (a) of this section—

(1) *In general*. The term ''engaged in trade or business within the United States'' does not include the effecting of transactions in the United States in stocks or securities through a resident broker, commission agent, custodian, or other independent agent. This subparagraph shall apply to any taxpayer, including a broker or dealer in stocks or securities, except that it shall not apply if at any time during the taxable year the taxpayer has an office or other fixed place of business in the United States through which, or by the direction of which, the transactions in stocks or securities are effected. The volume of stock or security transactions effected during the taxable year shall not be taken into account in determining under this subparagraph whether the taxpayer is engaged in trade or business within the United States.

(2) *Trading for taxpayer's own account*—(i) *In general*. The term ''engaged in trade or business within the United States'' does not include the effecting of transactions in the United States in stocks or securities for the taxpayer's own account, irrespective of whether such transactions are effected by or through—

(*a*) The taxpayer himself while present in the United States,

(*b*) Employees of the taxpayer, whether or not such employees are present in the United States while effecting the transactions, or

(*c*) A broker, commission agent, custodian, or other agent of the taxpayer, whether or not such agent while effecting the transactions is (*1*) dependent or independent, or (*2*) resident, nonresident, or present, in the United States, and irrespective of whether any such employee or agent has discretionary authority to make decisions in effecting such transactions. For purposes of this paragraph, the term ''securities'' means any note, bond, debenture, or other evidence of indebtedness, or any evidence of an interest in or right to subscribe to or purchase any of the foregoing; and the effecting of

transactions in stocks or securities includes buying, selling (whether or not by entering into short sales), or trading in stocks, securities, or contracts or options to buy or sell stocks or securities, on margin or otherwise, for the account and risk of the taxpayer, and any other activity closely related thereto (such as obtaining credit for the purpose of effectuating such buying, selling, or trading). The volume of stock of security transactions effected during the taxable year shall not be taken into account in determining under this subparagraph whether the taxpayer is engaged in trade or business within the United States. The application of this subdivision may be illustrated by the following example:

Example. A, a nonresident alien individual who is not a dealer in stocks or securities, authorizes B, an individual resident of the United States, as his agent to effect transactions in the United States in stocks and securities for the account of A. B is empowered with complete authority to trade in stocks and securities for the account of A and to use his own discretion as to when to buy or sell for A's account. This grant of discretionary authority from A to B is also communicated in writing by A to various domestic brokerage firms through which A ordinarily effects transactions in the United States in stocks or securities. Under the agency arrangement B has the authority to place orders with the brokers, and all confirmations are to be made by the brokers to B, subject to his approval. The brokers are authorized by A to make payments to B and to charge such payments to the account of A. In addition, B is authorized to obtain and advance the necessary funds, if any, to maintain credits with the brokerage firms. Pursuant to his authority B carries on extensive trading transactions in the United States during the taxable year through the various brokerage firms for the account of A. During the taxable year A makes several visits to the United States in order to discuss with B various aspects of his trading activities and to make necessary changes in his trading policy. A is not engaged in trade or business within the United States during the taxable year solely because of the effecting by B of transactions in the United States in stocks or securities during such year for the account of A.

(ii) *Partnerships*. A nonresident alien individual, foreign partnership, foreign estate, foreign trust, or foreign corporation shall not be considered to be engaged in trade or business within the United States solely because such person is a member of a partnership (whether domestic or foreign) which, pursuant to discretionary authority granted to such partnership by such person, effects transactions in the United States in stocks or securities for the partnership's own account or solely because an employee of such partnership, or a broker, commission agent, custodian, or other agent, pursuant to discretionary authority granted by such partnership, effects transactions in the United States in stocks or securities for the account of such partnership. This subdivision shall not apply, however, to any member of (*a*) a partnership which is a dealer in stocks or securities or (*b*) a partnership (other than a partnership in which, at any time during the last half of its taxable year, more than 50 percent of either the capital interest or the profits interest is owned, directly or indirectly, by five or fewer partners who are individuals) the principal business of which is trading in stocks or securities for its own account, if the principal office of such partnership is in the United States at any time during the taxable year. The principles of subdivision (iii) of this subparagraph for determining whether a foreign corporation has its principal office in the United States shall apply in determining under this subdivision whether a partnership has its principal office in the United States. See section 707(b)(3) and paragraph (b)(3) of §1.707–1 for rules for determining the extent of the ownership by a partner of a capital interest or profits interest in a partnership. The application of this subdivision may be illustrated by the following examples:

Example 1. B, a nonresident alien individual, is a member of partnership X, the members of which are U.S. citizens, nonresident alien individuals, and foreign corporations. The principal business of partnership X is trading in stocks or securities for its own account. Pursuant to discretionary authority granted by B, partnership X effects transactions in the United States in stocks or securities for its own account. Partnership X is not a dealer in stocks or securities, and more than 50 percent of either the capital interest or the profits interest in partnership X is owned throughout its taxable year by five or fewer partners who are individuals. B is not engaged in trade or business within the United States solely by

reason of such effecting of transactions in the United States in stocks or securities by partnership X for its own account.

Example 2. The facts are the same as in example 1, except that not more than 50 percent of either the capital interest or the profits interest in partnership X is owned throughout the taxable year by five or fewer partners who are individuals. However, partnership X does not maintain its principal office in the United States at any time during the taxable year. B is not engaged in trade or business within the United States solely by reason of the trading in stocks or securities by partnership X for its own account.

Example 3. The facts are the same as in example 1, except that, pursuant to discretionary authority granted by partnership X, domestic broker D effects transactions in the United States in stocks or securities for the account of partnership X. B is not engaged in trade or business in the United States solely by reason of such trading in stocks or securities for the account of partnership X.

(iii) *Dealers in stocks or securities and certain foreign corporations.* This subparagraph shall not apply to the effecting of transactions in the United States for the account of (*a*) a dealer in stocks or securities or (*b*) a foreign corporation (other than a corporation which is, or but for section 542(c)(7) or 543(b)(1)(C) would be, a personal holding company) the principal business of which is trading in stocks or securities for its own account, if the principal office of such corporation is in the United States at any time during the taxable year. Whether a foreign corporation's principal office is in the United States for this purpose is to be determined by comparing the activities (other than trading in stocks or securities) which the corporation conducts from its office or other fixed place of business located in the United States with the activities it conducts from its offices or other fixed places of business located outside the United States. For purposes of this subdivision, a foreign corporation is considered to have only one principal office, and an office of such corporation will not be considered to be its principal office merely because it is a statutory office of such corporation. For example, a foreign corporation which carries on most or all of its investment activities in the United States but maintains a general business office or offices outside the United States in which its management is located will not be considered as having its principal office in the United States if all or a substantial portion of the following functions is carried on at or from an office or offices located outside the United States:

(*1*) Communicating with its shareholders (including the furnishing of financial reports),

(*2*) Communicating with the general public,

(*3*) Soliciting sales of its own stock,

(*4*) Accepting the subscriptions of new stockholders,

(*5*) Maintaining its principal corporate records and books of account,

(*6*) Auditing its books of account,

(*7*) Disbursing payments of dividends, legal fees, accounting fees, and officers' and directors' salaries,

(*8*) Publishing or furnishing the offering and redemption price of the shares of stock issued by it,

(*9*) Conducting meetings of its shareholders and board of directors, and

(*10*) Making redemptions of its own stock.

The application of this subdivision may be illustrated by the following examples:

Example 1. (a) Foreign corporation X (not a corporation which is, or but for section 542(c)(7) or 543(b)(1)(C) would be, a personal holding company) was organized to sell its shares to nonresident alien individuals and foreign corporations and to invest the proceeds from the sale of such shares in stocks or securities in the United States. Foreign corporation X is engaged primarily in the business of investing, reinvesting, and trading in stocks or securities for its own account.

(b) For a period of three years, foreign corporation X irrevocably authorizes domestic corporation Y to exercise its discretion in effecting transactions in the United States in stocks or securities for the account and risk of foreign corporation X. Foreign corporation X issues a prospectus in which it is stated that its funds will be invested pursuant to an investment advisory contract with domestic corporation Y and otherwise advertises its services. Shares of foreign corporation X are sold to nonresident aliens and foreign corporations who are customers of the United States brokerage firms unrelated to domestic corporation Y or foreign corporation X. The principal functions performed for foreign corporation X by domestic corporation Y are the rendering of investment advice and the effecting of transactions in the United States in stocks or securities for the

account of foreign corporation X. Moreover, domestic corporation Y occasionally communicates with prospective foreign investors in foreign corporation X (through speaking engagements abroad by management of domestic corporation Y, and otherwise) for the purpose of explaining the investment techniques and policies used by domestic corporation Y in investing the funds of foreign corporation X. However, domestic corporation Y does not participate in the day-to-day conduct of other business activities of foreign corporation X.

(c) Foreign corporation X maintains a general business office or offices outside the United States in which its management is permanently located and from which it carries on, except to the extent noted heretofore, the functions enumerated in (*b*)(*1*) through (*10*) of this subdivision. The management of foreign corporation X at all times retains the independent power to cancel the investment advisory contract with domestic corporation Y subject to the contractual limitations contained therein and is in all other respects independent of the management of domestic corporation Y. The managing personnel of foreign corporation X communicate on a regular basis with domestic corporation Y, and periodically visit the offices of domestic corporation Y, in connection with the business activities of foreign corporation X.

(d) The principal office of foreign corporation X will not be considered to be in the United States; and, therefore, foreign corporation X is not engaged in trade or business within the United States solely by reason of its relationship with domestic corporation Y.

Example 2. The facts are the same as in example 1 except that, in lieu of having the investment advisory contract with domestic corporation Y, foreign corporation X has an office in the United States in which its employees perform the same functions as are performed by domestic corporation Y in example 1. Foreign corporation X is not engaged in trade or business within the United States during the taxable year solely because the employees located in its United States office effect transactions in the United States in stocks or securities for the account of that corporation.

(iv) *Definition of dealer in stocks or securities*—(*a*) *In general.* For purposes of this subparagraph, a dealer in stocks or securities is a merchant of stocks or securities, with an established place of business, regularly engaged as a merchant in purchasing stocks or securities and selling them to customers with a view to the gains and profits that may be derived therefrom. Persons who buy and sell, or hold, stocks or securities for investment or speculation, irrespective of whether such buying or selling constitutes the carrying on of a trade or business, and officers of corporations, members of partnerships, or fiduciaries, who in their individual capacities buy and sell, or hold, stocks or securities for investment or speculation are not dealers in stocks or securities within the meaning of this subparagraph solely by reason of that activity. In determining under this subdivision whether a person is a dealer in stocks or securities such person's transactions in stocks or securities effected both in and outside the United States shall be taken into account.

(*b*) *Underwriting syndicates and dealers trading for others.* A foreign person who otherwise may be considered a dealer in stocks or securities under (a) of this subdivision shall not be considered a dealer in stocks or securities for purposes of this subparagraph—

(*1*) Solely because he acts as an underwriter, or as a selling group member, for the purpose of making a distribution of stocks or securities of a domestic issuer to foreign purchasers of such stocks or securities, irrespective of whether other members of the selling group distribute the stocks or securities of the domestic issuer to domestic purchasers, or

(*2*) Solely because of transactions effected in the United States in stocks or securities pursuant to his grant of discretionary authority to make decisions in effecting those transactions, if he can demonstrate to the satisfaction of the Commissioner that the broker, commission agent, custodian, or other agent through whom the transactions were effected acted pursuant to his written representation that the funds in respect of which such discretion was granted were the funds of a customer who is neither a dealer in stocks or securities, a partnership described in subdivision (ii)(*b*) of this subparagraph, or a foreign corporation described in subdivision (iii)(*b*) of this subparagraph.

For purposes of this (*b*), a foreign person includes a nonresident alien individual, a foreign corporation, or a partnership any member of which is a nonresident alien individual or a foreign corporation. This (*b*) shall apply only if the foreign person at no time during

the taxable year has an office or other fixed place of business in the United States through which, or by the direction of which, the transactions in stocks or securities are effected.

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

Example 1. Foreign corporation X is a member of an underwriting syndicate organized to distribute stock issued by domestic corporation Y. Foreign corporation X distributes the stock of domestic corporation Y to foreign purchasers only. Domestic corporation M is syndicate manager of the underwriting syndicate and, pursuant to the terms of the underwriting agreement, reserves the right to sell certain quantities of the underwritten stock on behalf of all the members of the syndicate so as to engage in stabilizing transactions and to take certain other actions which may result in the realization of profit by all members of the underwriting syndicate. Foreign corporation X is not engaged in trade or business within the United States solely by reason of its participation as a member of such underwriting syndicate for the purpose of distributing the stock of domestic corporation Y to foreign purchasers or by reason of the exercise by M corporation of its discretionary authority as manager of such syndicate.

Example 2. Foreign corporation Y, a calendar year taxpayer, is a bank which trades in stocks or securities both for its own account and for the account of others. During 1967 foreign corporation Y authorizes domestic corporation M, a broker, to exercise its discretion in effecting transactions in the United States in stocks or securities for the account of B, a nonresident alien individual who has a trading account with foreign corporation Y. Foreign corporation Y furnishes a written representation to domestic corporation M to the effect that the funds in respect of which foreign corporation Y has authorized domestic corporation M to use its discretion in trading in the United States in stocks or securities are not funds in respect of which foreign corporation Y is trading for its own account but are the funds of one of its customers who is neither a dealer in stocks or securities, a partnership described in subdivision (ii)(*b*) of this subparagraph, or a foreign corporation described in subdivision (iii)(*b*) of this subparagraph. Pursuant to the discretionary authority so granted, domestic corporation M effects transactions in the United States during 1967 in stocks or securities for the account of the customer of foreign corporation Y. At no time during 1967 does foreign corporation Y have an office or other fixed place of business in the United States through which, or by the direction of which, such transactions in stocks or securities are effected by domestic corporation M. During 1967 foreign corporation Y is not engaged in trade or business within the United States solely by reason of such trading in stocks or securities during such year by domestic corporation M for the account of the customer of foreign corporation Y. Copies of the written representations furnished to domestic corporation M should be retained by foreign corporation Y for inspection by the Commissioner, if inspection is requested.

(d) *Trading in commodities*. For purposes of paragraph (a) of this section—

(1) *In general*. The term ''engaged in trade or business within the United States'' does not include the effecting of transactions in the United States in commodities (including hedging transactions) through a resident broker, commission agent, custodian, or other independent agent if (i) the commodities are of a kind customarily dealt in on an organized commodity exchange, such as a grain futures or a cotton futures market, (ii) the transaction is of a kind customarily consummated at such place, and (iii) the taxpayer at no time during the taxable year has an office or other fixed place of business in the United States through which, or by the direction of which, the transactions in commodities are effected. The volume of commodity transactions effected during the taxable year shall not be taken into account in determining under this subparagraph whether the taxpayer is engaged in trade or business in the United States.

(2) *Trading for taxpayer's own account*—(i) *In general*. The term ''engaged in trade or business within the United States'' does not include the effecting of transactions in the United States in commodities (including hedging transactions) for the taxpayer's own account if the commodities are of a kind customarily dealt in on an organized commodity exchange and if the transaction is of a kind customarily consummated at such place. This rule shall apply irrespective of whether such transactions are effected by or through—

(*a*) The taxpayer himself while present in the United States,

(*b*) Employees of the taxpayer, whether or not such employees are present in the United States while effecting the transactions, or

(*c*) A broker, commission, agent, custodian, or other agent of the taxpayer, whether or not such agent while effecting the transactions is (*1*) dependent or independent, or (*2*) resident, nonresident, or present, in the United States, and irrespective of whether any such employee or agent has discretionary authority to make decisions in effecting such transactions. The volume of commodity transactions effected during the taxable year shall not be taken into account in determining under this subparagraph whether the taxpayer is engaged in trade or business within the United States. This subparagraph shall not apply to the effecting of transactions in the United States for the account of a dealer in commodities.

(ii) *Partnerships.* A nonresident alien individual, foreign partnership, foreign estate, foreign trust, or foreign corporation shall not be considered to be engaged in trade or business within the United States solely because such person is a member of a partnership (whether domestic or foreign) which, pursuant to discretionary authority granted to such partnership by such person, effects transactions in the United States in commodities for the partnership's account or solely because an employee of such partnership, or a broker, commission agent, custodian, or other agent, pursuant to discretionary authority granted by such partnership, effects transactions in the United States in commodities for the account of such partnership. This subdivision shall not apply to any member of a partnership which is a dealer in commodities.

(iii) *Illustration.* The application of this subparagraph may be illustrated by the following example:

Example. Foreign corporation X, a calendar year taxpayer, is engaged as a merchant in the business of purchasing grain in South America and selling such cash grain outside the United States under long-term contracts for delivery in foreign countries. Foreign corporation X consummates a sale of 100,000 bushels of cash grain in February 1967 for July delivery to Sweden. Because foreign corporation X does not actually own such grain at the time of the sales transaction, such corporation buys as a hedge a July ''futures contract'' for delivery of 100,000 bushels of grain, in order to protect itself from loss by reason of a possible rise in the price of grain between February and July. The ''futures contract'' is ordered through domestic corporation Y, a futures commission merchant registered under the Commodity Exchange Act. Foreign corporation X is not engaged in trade or business within the United States during 1967 solely by reason of its effecting of such futures contract for its own account through domestic corporation Y.

(3) *Definition of commodity.* For purposes of section 864(b)(2)(B) and this paragraph the term ''commodities'' does not include goods or merchandise in the ordinary channels of commerce.

(e) *Other rules.* The fact that a person is not determined by reason of this section to be not engaged in trade or business with the United States is not to be considered a determination that such person is engaged in trade or business within the United States. Whether or not such person is engaged in trade or business within the United States shall be determined on the basis of the facts and circumstances in each case. For other rules relating to the determination of whether a taxpayer is engaged in trade or business in the United States see section 875 and the regulations thereunder.

(f) *Effective date.* The provisions of this section shall apply only in the case of taxable years beginning after December 31, 1966.

[T.D. 6948, 33 FR 5090, Mar. 28, 1968, as amended by T.D. 7378, 40 FR 45435, Oct. 2, 1975]

§ 1.864–3 Rules for determining income effectively connected with U.S. business of nonresident aliens or foreign corporations.

(a) *In general.* For purposes of the Internal Revenue Code, in the case of a nonresident alien individual or a foreign corporation that is engaged in a trade or business in the United States at any time during the taxable year, the rules set forth in §§ 1.864–4 through 1.864–7 and this section shall apply in determining whether income, gain, or loss shall be treated as effectively connected for a taxable year beginning after December 31, 1966, with the conduct of a trade or business in the United States. Except as provided in sections 871 (c) and (d) and 882 (d) and (e), and the regulations thereunder, in the case of a nonresident alien individual or a foreign corporation that is

at no time during the taxable year engaged in a trade or business in the United States, no income, gain, or loss shall be treated as effectively connected for the taxable year with the conduct of a trade or business in the United States. The general rule prescribed by the preceding sentence shall apply even though the income, gain, or loss would have been treated as effectively connected with the conduct of a trade or business in the United States if such income or gain had been received or accrued, or such loss had been sustained, in an earlier taxable year when the taxpayer was engaged in a trade or business in the United States. In applying §§ 1.864–4 through 1.864–7 and this section, the determination whether an item of income, gain, or loss is effectively connected with the conduct of a trade or business in the United States shall not be controlled by any administrative, judicial, or other interpretation made under the laws of any foreign country.

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

Example 1. During 1967 foreign corporation N, which uses the calendar year as the taxable year, is engaged in the business of purchasing and selling household equipment on the installment plan. During 1967 N is engaged in business in the United States by reason of the sales activities it carries on in the United States for the purpose of selling therein some of the equipment which it has purchased. During 1967 N receives installment payments of $800,000 on sales it makes that year in the United States, and the income from sources within the United States for 1967 attributable to such payments is $200,000. By reason of section 864(c)(3) and paragraph (b) of § 1.864–4 this income of $200,000 is effectively connected for 1967 with the conduct of a trade or business in the United States by N. In December of 1967, N discontinues its efforts to make any further sales of household equipment in the United States, and at no time during 1968 is N engaged in a trade or business in the United States. During 1968 N receives installment payments of $500,000 on the sales it made in the United States during 1967, and the income from sources within the United States for 1968 attributable to such payments is $125,000. By reason of section 864(c)(1)(B) and this section, this income of $125,000 is not effectively connected for 1968 with the conduct of a trade or business in the United States by N, even though such amount, if it had been received by N during 1967, would have been effectively connected for 1967 with the conduct of a trade or business in the United States by that corporation.

Example 2. R, a foreign holding company, owns all of the voting stock in five corporations, two of which are domestic corporations. All of the subsidiary corporations are engaged in the active conduct of a trade or business. R has an office in the United States where its chief executive officer, who is also the chief executive officer of one of the domestic corporations, spends a substantial portion of the taxable year supervising R's investment in its operating subsidiaries and performing his function as chief executive officer of the domestic operating subsidiary. R is not considered to be engaged in a trade or business in the United States during the taxable year by reason of the activities carried on in the United States by its chief executive officer in the supervision of its investment in its operating subsidiary corporations. Accordingly, the dividends from sources within the United States received by R during the taxable year from its domestic subsidiary corporations are not effectively connected for that year with the conduct of a trade or business in the United States by R.

Example 3. During the months of June through December 1971, B, a nonresident alien individual who uses the calendar year as the taxable year and the cash receipts and disbursements method of accounting, is employed in the United States by domestic corporation M for a salary of $2,000 per month, payable semimonthly. During 1971, B receives from M salary payments totaling $13,000, all of which income by reason of section 864(c)(2) and paragraph (c)(6)(ii) of § 1.864–4, is effectively connected for 1971 with the conduct of a trade or business in the United States by B. On December 31, 1971, B terminates his employment with M and departs from the United States. At no time during 1972 is B engaged in a trade or business in the United States. In January of 1972, B receives from M salary of $1,000 for the last half of December 1971, and a bonus of $1,000 in consideration of the services B performed in the United States during 1971 for that corporation. By reason of section 864(c)(1)(B) and this section, the $2,000 received by B during 1972 from sources within the United States is not effectively connected for that year with the conduct of a trade or business in the United States, even though such amount, if it had been received by B during 1971, would have been effectively connected for 1971 with the conduct of a trade or business in the United States by B.

[T.D. 7216, 37 FR 23424, Nov. 3, 1972]

§ 1.864–4 U.S. source income effectively connected with U.S. business.

(a) *In general.* This section applies only to a nonresident alien individual or a foreign corporation that is engaged in a trade or business in the United States at some time during a taxable year beginning after December 31, 1966, and to the income, gain, or loss of such person from sources within the United States. If the income, gain, or loss of such person for the taxable year from sources within the United States consists of (1) gain or loss from the sale or exchange of capital assets or (2) fixed or determinable annual or periodical gains, profits, and income or certain other gains described in section 871(a)(1) or 881(a), certain factors must be taken into account, as prescribed by section 864(c)(2) and paragraph (c) of this section, in order to determine whether the income, gain, or loss is effectively connected for the taxable year with the conduct of a trade or business in the United States by that person. All other income, gain, or loss of such person for the taxable year from sources within the United States shall be treated as effectively connected for the taxable year with the conduct of a trade or business in the United States by that person, as prescribed by section 864(c)(3) and paragraph (b) of this section.

(b) *Income other than fixed or determinable income and capital gains.* All income, gain, or loss for the taxable year derived by a nonresident alien individual or foreign corporation engaged in a trade or business in the United States from sources within the United States which does not consist of income, gain, or loss described in section 871(a)(1) or 881(a), or of gain or loss from the sale or exchange of capital assets, shall, for purposes of paragraph (a) of this section, be treated as effectively connected for the taxable year with the conduct of a trade or business in the United States. This income, gain, or loss shall be treated as effectively connected for the taxable year with the conduct of a trade or business in the United States, whether or not the income, gain, or loss is derived from the trade or business being carried on in the United States during the taxable year. The application of this paragraph may be illustrated by the following examples:

Example 1. M, a foreign corporation which uses the calendar year as the taxable year, is engaged in the business of manufacturing machine tools in a foreign country. It establishes a branch office in the United States during 1968 which solicits orders from customers in the United States for the machine tools manufactured by that corporation. All negotiations with respect to such sales are carried on in the United States. By reason of its activity in the United States M is engaged in business in the United States during 1968. The income or loss from sources within the United States from such sales during 1968 is treated as effectively connected for that year with the conduct of a business in the United States by M. Occasionally, during 1968 the customers in the United States write directly to the home office of M, and the home office makes sales directly to such customers without routing the transactions through its branch office in the United States. The income or loss from sources within the United States for 1968 from these occasional direct sales by the home office is also treated as effectively connected for that year with the conduct of a business in the United States by M.

Example 2. The facts are the same as in example 1 except that during 1967 M was also engaged in the business of purchasing and selling office machines and that it used the installment method of accounting for the sales made in this separate business. During 1967 M was engaged in business in the United States by reason of the sales activities it carried on in the United States for the purpose of selling therein a number of the office machines which it had purchased. Although M discontinued this business activity in the United States in December of 1967, it received in 1968 some installment payments on the sales which it had made in the United States during 1967. The income of M for 1968 from sources within the United States which is attributable to such installment payments is effectively connected for 1968 with the conduct of a business in the United States, even though such income is not connected with the business carried on in the United States during 1968 through its sales office located in the United States for the solicitation of orders for the machine tools it manufactures.

Example 3. Foreign corporation S, which uses the calendar year as the taxable year, is engaged in the business of purchasing and selling electronic equipment. The home office of such corporation is also engaged in the business of purchasing and selling vintage wines. During 1968, S establishes a branch office in the United States to sell electronic equipment to customers, some of whom are located in the United States and the balance, in foreign countries. This

branch office is not equipped to sell, and does not participate in sales of, wine purchased by the home office. Negotiations for the sales of the electronic equipment take place in the United States. By reason of the activity of its branch office in the United States, S is engaged in business in the United States during 1968. As a result of advertisements which the home office of S places in periodicals sold in the United States, customers in the United States frequently place orders for the purchase of wines with the home office in the foreign country, and the home office makes sales of wine in 1968 directly to such customers without routing the transactions through its branch office in the United States. The income or loss from sources within the United States for 1968 from sales of electronic equipment by the branch office, together with the income or loss from sources within the United States for that year from sales of wine by the home office, is treated as effectively connected for that year with the conduct of a business in the United States by S.

(c) *Fixed or determinable income and capital gains*—(1) *Principal factors to be taken into account*—(i) *In general.* In determining for purposes of paragraph (a) of this section whether any income for the taxable year from sources within the United States which is described in section 871(a)(1) or 881(a), relating to fixed or determinable annual or periodical gains, profits, and income and certain other gains, or whether gain or loss from sources within the United States for the taxable year from the sale or exchange of capital assets, is effectively connected for the taxable year with the conduct of a trade or business in the United States, the principal tests to be applied are (a) the asset-use test, that is, whether the income, gain, or loss is derived from assets used in, or held for use in, the conduct of the trade or business in the United States, and (b) the business-activities test, that is, whether the activities of the trade or business conducted in the United States were a material factor in the realization of the income, gain, or loss.

(ii) *Special rule relating to interest on certain deposits.* For purposes of determining under section 861(a)(1)(A) (relating to interest on deposits with banks, savings and loan associations, and insurance companies paid or credited before January 1, 1976) whether the interest described therein is effectively connected for the taxable year with the conduct of a trade or business in the United States, such interest shall be treated as income from sources within the United States for purposes of applying this paragraph and §1.864–5. If by reason of the application of this paragraph such interest is determined to be income which is not effectively connected for the taxable year with the conduct of a trade or business in the United States, it shall then be treated as interest from sources without the United States which is not subject to the application of §1.864–5.

(2) *Application of the asset-use test*—(i) *In general.* For purposes of subparagraph (1) of this paragraph, the asset-use test ordinarily shall apply in making a determination with respect to income, gain, or loss of a passive type where the trade or business activities as such do not give rise directly to the realization of the income, gain, or loss. However, even in the case of such income, gain, or loss, any activities of the trade or business which materially contribute to the realization of such income, gain, or loss shall also be taken into account as a factor in determining whether the income, gain, or loss is effectively connected with the conduct of a trade or business in the United States. The asset-use test is of primary significance where, for example, interest income is derived from sources within the United States by a nonresident alien individual or foreign corporation that is engaged in the business of manufacturing or selling goods in the United States. See also subparagraph (5) of this paragraph for rules applicable to taxpayers conducting a banking, financing, or similar business in the United States.

(ii) *Cases where applicable.* Ordinarily, an asset shall be treated as used in, or held for use in, the conduct of a trade or business in the United States if the asset is—

(*a*) Held for the principal purpose of promoting the present conduct of the trade or business in the United States; or

(*b*) Acquired and held in the ordinary course of the trade or business conducted in the United States, as, for example, in the case of an account or note receivable arising from that trade or business; or

(*c*) Otherwise held in a direct relationship to the trade or business conducted in the United States, as determined under paragraph (c)(2)(iv) of this section.

(iii) *Application of asset-use test to stock*—(*a*) *In general*. Except as provided in paragraph (c)(2)(iii)(*b*) of this section, stock of a corporation (whether domestic or foreign) shall not be treated as an asset used in, or held for use in, the conduct of a trade or business in the United States.

(*b*) *Stock held by foreign insurance companies*. This paragraph (c)(2)(iii) shall not apply to stock of a corporation (whether domestic or foreign) held by a foreign insurance company unless the foreign insurance company owns 10 percent or more of the total voting power or value of all classes of stock of such corporation. For purposes of this section, section 318(a) shall be applied in determining ownership, except that in applying section 318(a)(2)(C), the phrase ''10 percent'' is used instead of the phrase ''50 percent.''

(iv) *Direct relationship between holding of asset and trade or business*—(*a*) *In general*. In determining whether an asset is held in a direct relationship to the trade or business conducted in the United States, principal consideration shall be given to whether the asset is needed in that trade or buisness. An asset shall be considered needed in a trade or business, for this purpose, only if the asset is held to meet the present needs of that trade or business and not its anticipated future needs. An asset shall be considered as needed in the trade or business conducted in the United States if, for example, the asset is held to meet the operating expenses of that trade or business. Conversely, an asset shall be considered as not needed in the trade or business conducted in the United States if, for example, the asset is held for the purpose of providing for (*1*) future diversification into a new trade or business, (*2*) expansion of trade or business activities conducted outside of the United States, (*3*) future plant replacement, or (*4*) future business contingencies.

(*b*) Presumption of direct relationship. Generally, an asset will be treated as held in a direct relationship to the trade or business if (*1*) the asset was acquired with funds generated by that trade or business, (*2*) the income from the asset is retained or reinvested in that trade or business, and (*3*) personnel who are present in the United States and actively involved in the conduct of that trade or business exercise significant management and control over the investment of such asset.

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

Example 1. M, a foreign corporation which uses the calendar year as the taxable year, is engaged in industrial manufacturing in a foreign country. M maintains a branch in the United States which acts as importer and distributor of the merchandise it manufactures abroad; by reason of these branch activities. M is engaged in business in the United States during 1968. The branch in the United States is required to hold a large current cash balance for business purposes, but the amount of the cash balance so required varies because of the fluctuating seasonal nature of the branch's business. During 1968 at a time when large cash balances are not required the branch invests the surplus amount in U.S. Treasury bills. Since these Treasury bills are held to meet the present needs of the business conducted in the United States they are held in a direct relationship to that business, and the interest for 1968 on these bills is effectively connected for that year with the conduct of the business in the United States by M.

Example 2. Foreign corporation M, which uses the calendar year as the taxable year, has a branch office in the United States where it sells to customers located in the United States various products which are manufactured by that corporation in a foreign country. By reason of this activity M is engaged in business in the United States during 1997. The U.S. branch establishes in 1997 a fund to which are periodically credited various amounts which are derived from the business carried on at such branch. The amounts in this fund are invested in various securities issued by domestic corporations by the managing officers of the U.S. branch, who have the responsibility for maintaining proper investment diversification and investment of the fund. During 1997, the branch office derives from sources within the United States interest on these securities, and gains and losses resulting from the sale or exchange of such securities. Since the securities were acquired with amounts generated by the business conducted in the United States, the interest is retained in that business, and the portfolio is managed by personnel actively involved in the conduct of that business, the securities are presumed under paragraph (c)(2)(iv)(*b*) of this section

to be held in a direct relationship to that business. However, M is able to rebut this presumption by demonstrating that the fund was established to carry out a program of future expansion and not to meet the present needs of the business conducted in the United States. Consequently, the income, gains, and losses from the securities for 1997 are not effectively connected for that year with the conduct of a trade or business in the United States by M.

(3) *Application of the business-activities test*—(i) *In general.* For purposes of subparagraph (1) of this paragraph, the business-activities test shall ordinarily apply in making a determination with respect to income, gain, or loss which, even though generally of the passive type, arises directly from the active conduct of the taxpayer's trade or business in the United States. The business-activities test is of primary significance, for example, where (*a*) dividends or interest are derived by a dealer in stocks or securities, (*b*) gain or loss is derived from the sale or exchange of capital assets in the active conduct of a trade or business by an investment company, (*c*) royalties are derived in the active conduct of a business consisting of the licensing of patents or similar intangible property, or (*d*) service fees are derived in the active conduct of a servicing business. In applying the business-activities test, activities relating to the management of investment portfolios shall not be treated as activities of the trade or business conducted in the United States unless the maintenance of the investments constitutes the principal activity of that trade or business. See also subparagraph (5) of this paragraph for rules applicable to taxpayers conducting a banking, financing, or similar business in the United States.

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

Example 1. Foreign corporation S is a foreign investment company organized for the purpose of investing in stocks and securities. S is not a personal holding company or a corporation which would be a personal holding company but for section 542(c)(7) or 543(b)(1)(C). Its investment portfolios consist of common stocks issued by both foreign and domestic corporations and a substantial amount of high grade bonds. The business activity of S consists of the management of its portfolios for the purpose of investing, reinvesting, or trading in stocks and securities. During the taxable year 1968, S has its principal office in the United States within the meaning of paragraph (c)(2)(iii) of §1.864–2 and, by reason of its trading in the United States in stocks and securities, is engaged in business in the United States. The dividends and interest derived by S during 1968 from sources within the United States, and the gains and losses from sources within the United States for such year from the sale of stocks and securities from its investment portfolios, are effectively connected for 1968 with the conduct of the business in the United States by that corporation, since its activities in connection with the management of its investment portfolios are activities of that business and such activities are a material factor in the realization of such income, gains, and losses.

Example 2. N, a foreign corporation which uses the calendar year as the taxable year, has a branch in the United States which acts as an importer and distributor of merchandise; by reason of the activities of that branch, N is engaged in business in the United States during 1968. N also carries on a business in which it licenses patents to unrelated persons in the United States for use in the United States. The businesses of the licensees in which these patents are used have no direct relationship to the business carried on in N's branch in the United States, although the merchandise marketed by the branch is similar in type to that manufactured under the patents. The negotiations and other activities leading up to the consummation of these licenses are conducted by employees of N who are not connected with the U.S. branch of that corporation, and the U.S. branch does not otherwise participate in arranging for the licenses. Royalties received by N during 1968 from these licenses are not effectively connected for that year with the conduct of its business in the United States because the activities of that business are not a material factor in the realization of such income.

(4) *Method of accounting as a factor.* In applying the asset-use test or the business-activities test described in subparagraph (1) of this paragraph, due regard shall be given to whether or not the asset, or the income, gain, or loss, is accounted for through the trade or business conducted in the United States, that is, whether or not the asset, or the income, gain, or loss, is carried on books of account separately kept for that trade or business, but this accounting test shall not by itself be controlling. In applying this subparagraph, consideration shall be given to whether the accounting treatment of

an item reflects the consistent application of generally accepted accounting principles in a particular trade or business in accordance with accepted conditions or practices in that trade or business and whether there is a consistent accounting treatment of that item from year to year by the taxpayer.

(5) *Special rules relating to banking, financing, or similar business activity*—(i) *Definition of banking, financing, or similar business.* A nonresident alien individual or a foreign corporation shall be considered for purposes of this section and paragraph (b)(2) of §1.864–5 to be engaged in the active conduct of a banking, financing, or similar business in the United States if at some time during the taxable year the taxpayer is engaged in business in the United States and the activities of such business consist of any one or more of the following activities carried on, in whole or in part, in the United States in transactions with persons situated within or without the United States:

(*a*) Receiving deposits of funds from the public,

(*b*) Making personal, mortgage, industrial, or other loans to the public,

(*c*) Purchasing, selling, discounting, or negotiating for the public on a regular basis, notes, drafts, checks, bills of exchange, acceptances, or other evidences of indebtedness,

(*d*) Issuing letters of credit to the public and negotiating drafts drawn thereunder,

(*e*) Providing trust services for the public, or

(*f*) Financing foreign exchange transactions for the public.

Although the fact that the taxpayer is subjected to the banking and credit laws of a foreign country shall be taken into account in determining whether he is engaged in the active conduct of a banking, financing, or similar business, the character of the business actually carried on during the taxable year in the United States shall determine whether the taxpayer is actively conducting a banking, financing, or similar business in the United States. A foreign corporation which acts merely as a financing vehicle for borrowing funds for its parent corporation or any other person who would be a related person within the meaning of section 954(d)(3) if such foreign corporation were a controlled foreign corporation shall not be considered to be engaged in the active conduct of a banking, financing, or similar business in the United States.

(ii) *Effective connection of income from stocks or securities with active conduct of a banking, financing, or similar business.* Notwithstanding the rules in subparagraphs (2) and (3) of this paragraph with respect to the asset-use test and the business-activities test, any dividends or interest from stocks or securities, or any gain or loss from the sale or exchange of stocks or securities which are capital assets, which is from sources within the United States and derived by a nonresident alien individual or a foreign corporation in the active conduct during the taxable year of a banking, financing, or similar business in the United States shall be treated as effectively connected for such year with the conduct of that business only if the stocks or securities giving rise to such income, gain, or loss are attributable to the U.S. office through which such business is carried on and—

(*a*) Were acquired—

(*1*) As a result of, or in the course of making loans to the public,

(*2*) In the course of distributing such stocks or securities to the public, or

(*3*) For the purpose of being used to satisfy the reserve requirements, or other requirements similar to reserve requirements, established by a duly constituted banking authority in the United States, or

(*b*) Consist of securities (as defined in subdivision (v) of this subparagraph) which are—

(*1*) Payable on demand or at a fixed maturity date not exceeding 1 year from the date of acquisition,

(*2*) Issued by the United States, or any agency or instrumentality thereof, or

(*3*) Not described in (*a*) or in (*1*) or (*2*) of this (*b*).

However, the amount of interest from securities described in (*b*)(*3*) of this subdivision (ii) which shall be treated as effectively connected for the taxable year with the active conduct of a banking, financing, or similar business in

the United States shall be an amount (but not in excess of the entire interest for the taxable year from sources within the United States from such securities) determined by multiplying the entire interest for the taxable year from sources within the United States from such securities by a fraction the numerator of which is 10 percent and the denominator of which is the same percentage, determined on the basis of a monthly average for the taxable year, as the book value of the total of such securities held by the U.S. office through which such business is carried on bears to the book value of the total assets of such office. The amount of gain or loss, if any, for the taxable year from the sale or exchange of such securities which shall be treated as effectively connected for the taxable year with the active conduct of a banking, financing, or similar business in the United States shall be an amount (but not in excess of the entire gain or loss for the taxable year from sources within the United States from the sale or exchange of such securities) determined by multiplying the entire gain or loss for the taxable year from sources within the United States from the sale or exchange of such securities by the fraction described in the immediately preceding sentence. The percentage of the denominator of the limiting fraction for such purposes shall be the percentage obtained by separately adding the book value of such securities and such total assets held at the close of each month in the taxable year, dividing each such sum by 12, and then dividing the amount of securities so obtained by the amount of assets so obtained. This subdivision does not apply to dividends from stock owned by a foreign corporation in a domestic corporation of which more than 50 percent of the total combined voting power of all classes of stock entitled to vote is owned by such foreign corporation and which is engaged in the active conduct of a banking business in the United States. The application of this subdivision may be illustrated by the following example:

Example. Foreign corporation M, created under the laws of foreign country Y, has in the United States a branch, B, which during the taxable year is engaged in the active conduct of the banking business in the United States within the meaning of subdivision (i) of this subparagraph. During the taxable year M derives from sources within the United States through the activities carried on through B, $7,500,000 interest from securities described in subdivision (*b*)(*3*) of this subdivision (ii) and $7,500,000 gain from the sale or exchange of such securities. The monthly average, determined as of the last day of each month in the taxable year, of such securities held by B divided by the monthly average, as so determined, of the total assets held by B equals 15 percent. Under this subdivision, the amount of interest income from such securities that shall be treated as effectively connected for the taxable year with the active conduct by M of a banking business in the United States is $5 million ($7,500,000 interest × 10% / 15%), and the amount of gain from the sale or exchange of such securities that shall be treated as effectively connected for such year with the active conduct of such business is $5 million ($7,500,000 gain × 10% / 15%).

(iii) *Stocks or securities attributable to U.S. office*—(*a*) *In general*. For purposes of paragraph (c)(5)(ii) of this section, a stock or security shall be deemed to be attributable to a U.S. office only if such office actively and materially participated in soliciting, negotiating, or performing other activities required to arrange the acquisition of the stock or security. The U.S. office need not have been the only active participant in arranging the acquisition of the stock or security.

(*b*) *Exceptions*. A stock or security shall not be deemed to be attributable to a U.S. office merely because such office conducts one or more of the following activities:

(*1*) Collects or accounts for the dividends, interest, gain, or loss from such stock or security,

(*2*) Exercises general supervision over the activities of the persons directly responsible for carrying on the activities described in paragraph (c)(5)(iii)(*a*) of this section,

(*3*) Performs merely clerical functions incident to the acquisition of such stock or security,

(*4*) Exercises final approval over the execution of the acquisition of such stock or security, or

(*5*) Holds such stock or security in the United States or records such stock or security on its books or records as having been acquired by such office or for its account.

(*c*) *Effective date.* This paragraph (c)(5)(iii) shall be effective for income includible in taxable years beginning on or after June 18, 1984, except that 26 CFR 1.864–4 (c)(5)(iii) as it appeared in the Code of Federal Regulations revised as of April 1, 1983, shall apply to income received or accured under a loan made by the taxpayer on or before May 18, 1984, or pursuant to a written binding commitment entered into on or before May 18, 1984.

(iv) *Acquisitions in course of making loans to the public.* For purposes of subdivision (ii) of this subparagraph—

(*a*) A stock or security shall be considered to have been acquired in the course of making a loan to the public where, for example, such stock or security was acquired as additional consideration for the making of the loan,

(*b*) A stock or security shall be considered to have been acquired as a result of making a loan to the public if, for example, such stock or security was acquired by foreclosure upon a bona fide default of the loan and is held as an ordinary and necessary incident to the active conduct of the banking, financing, or similar business in the United States, and

(*c*) A stock or security acquired on a stock exchange or organized over-the-counter market shall be considered not to have been acquired as a result of, or in the course of, making loans to the public.

(v) *Security defined.* For purposes of this subparagraph, a security is any bill, note, bond, debenture, or other evidence of indebtedness, or any evidence of an interest in, or right to subscribe to or purchase, any of the foregoing items.

(vi) *Limitations on application of subparagraph—(a) Other business activity.* This subparagraph provides rules for determining when certain income from stocks or securities is effectively connected with the active conduct of a banking, financing, or similar business in the United States. Any dividends, interest, gain, or loss from sources within the United States which by reason of the application of subdivision (ii) of this subparagraph is not effectively connected with the active conduct by a nonresident alien individual or a foreign corporation of a banking, financing, or similar business in the United States may be effectively connected for the taxable year, under subparagraph (2) or (3) of this paragraph with the conduct by such taxpayer of another trade or business in the United States, such as, for example, the business of selling or manufacturing goods or merchandise or of trading in stocks or securities for the taxpayer's own account.

(*b*) *Other income.* For rules relating to income, gain, or loss from sources within the United States (other than dividends or interest from, or gain or loss from the sale or exchange of, stocks or securities referred to in subdivision (ii) of this subparagraph) derived in the active conduct of a banking, financing, or similar business in the United States, see subparagraphs (2) and (3) of this paragraph and paragraph (b) of this section.

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

Example 1. Foreign corporation F, which is created under the laws of foreign country X and engaged in the active conduct of the banking business in country X and a number of other foreign countries, has in the United States a branch, B, which during the taxable year is engaged in the active conduct of the banking business in the United States within the meaning of subdivision (i) of this subparagraph. In the course of its banking business in foreign countries, F receives at its branches located in country X and other foreign countries substantial deposits in U.S. dollars which are transferred to the accounts of B in the United States. During the taxable year, B actively participates in negotiating loans to residents of the United States, such as call loans to U.S. brokers, which are financed from the U.S. dollar deposits transferred to B by F. In addition, B actively participates in purchasing on the New York Stock Exchange and over-the-counter markets long-term bonds and notes issued by the U.S. Government, U.S. Treasury bills, and long-term interest-bearing bonds issued by domestic corporations and having a maturity date of less than 1 year from the date of acquisition, all of which are purchased from the deposits transferred to B by F. All of the securities so acquired are held by B and recorded on its books in the United States. Pursuant to subdivision (ii) of this subparagraph, the interest received by F during the taxable year on these loans, bonds, notes, and bills is effectively connected for such year with the active conduct by F of a banking business in the United States.

Example 2. The facts are the same as in example 1 except that B also actively participates in using part of the U.S. dollar deposits, which are transferred to it by F, to purchase on the New York Stock Exchange shares of common stock issued by various domestic corporations. All of the shares so purchased are considered to be capital assets within the meaning of section 1221 and are recorded on B's books in the United States. None of the shares so purchased were acquired for the purpose of meeting reserve or other similar requirements. During the taxable year some of the shares are sold by B on the stock exchange. Pursuant to subdivision (ii) of this subparagraph, the dividends and gains received by F during the taxable year on these shares of stock are not effectively connected with the active conduct by F of a banking, financing, or similar business in the United States.

Example 3. The facts are the same as in example 1 except that B also uses part of the U.S. dollar deposits, which are transferred to it by F, to make a loan to domestic corporation M. As part of the consideration for the loan, M gives to B a number of shares of common stock issued by M. All of these shares of stock are considered to be capital assets within the meaning of section 1221 and are recorded on B's books in the United States. During the taxable year one-half of these shares of stock is sold by B on the New York Stock Exchange. Pursuant to subdivision (ii) of this subparagraph, the dividends and gains received by F during the taxable year on these shares of stock are effectively connected for such year with the active conduct by F of a banking business in the United States.

Example 4. The facts are the same as in example 1 except that during the taxable year the home office of F in country X actively participates in negotiating loans to residents of the United States, such as call loans to U.S. brokers, which are financed by the U.S. dollar deposits received at the home office and are recorded on the books of the home office. B does not participate in negotiating these loans. Pursuant to subdivision (ii) of this subparagraph the interest received by F during the taxable year on these loans made by the home office in country X is not effectively connected with the active conduct by F of a banking, financing, or similar business in the United States.

Example 5. Foreign corporation *Y*, which is created under the laws of foreign country X and is engaged in the active conduct of a banking business in country X and other foreign countries, has a branch, *C*, in the United States that is engaged in the active conduct of a banking business in the United States, within the meaning of paragraph (c)(5)(i) of this section, during the taxable year. *C* handles the negotiation and acquisition of securities involved in loans made by *Y* to U.S. persons. *C* also presents interest coupons with respect to such securities for payment, presents all such securities for payment at maturity, and maintains compete photocopy files with respect to such securities. The activities of the office of *Y* in country X with respect to these securities consist of giving pro forma approval of the loans, storing the original securities, and recording the securities on the books of the country X office. Pursuant to paragraphs (c)(5)(ii) and (c)(5)(iii) of this section, the U.S. source interest income received by *Y* during the taxable year on these securities is effectively connected for such year with the active conduct by *Y* of a banking business in the United States.

(6) *Income related to personal services of an individual*—(i) *Income, gain, or loss from assets.* Income or gains from sources within the United States described in section 871(a)(1) and derived from an asset, and gain or loss from sources within the United States from the sale or exchange of capital assets, realized by a nonresident alien individual engaged in a trade or business in the United States during the taxable year solely by reason of his performing personal services in the United States shall not be treated as income, gain, or loss which is effectively connected for the taxable year with the conduct of a trade or business in the United States, unless there is a direct economic relationship between his holding of the asset from which the income, gain, or loss results and his trade or business of performing the personal services.

(ii) *Wages, salaries, and pensions.* Wages, salaries, fees, compensations, emoluments, or other remunerations, including bonuses, received by a nonresident alien individual for performing personal services in the United States which, under paragraph (a) of § 1.864–2, constitute engaging in a trade or business in the United States, and pensions and retirement pay attributable to such personal services, constitute income which is effectively connected for the taxable year with the conduct of a trade or business in the United States by that individual if he is engaged in a trade or business in the United States at some time during the taxable year in which such income is received.

(7) *Effective date.* Paragraphs (c)(2) and (c)(6)(i) of this section are effective

for taxable years beginning on or after June 6, 1996.

[T.D. 7216, 37 FR 23425, Nov. 3, 1972, as amended by T.D. 7332, 39 FR 44232, Dec. 23, 1974; T.D. 79–58, 49 FR 21052, May 18, 1984; T.D. 8657, 61 FR 9337, Mar. 8, 1996; T.D. 9226, 70 FR 57510, Oct. 3, 2005]

§ 1.864–5 Foreign source income effectively connected with U.S. business.

(a) *In general.* This section applies only to a nonresident alien individual or a foreign corporation that is engaged in a trade or business in the United States at some time during a taxable year beginning after December 31, 1966, and to the income, gain, or loss of such person from sources without the United States. The income, gain, or loss of such person for the taxable year from sources without the United States which is specified in paragraph (b) of this section shall be treated as effectively connected for the taxable year with the conduct of a trade or business in the United States, only if he also has in the United States at some time during the taxable year, but not necessarily at the time the income, gain, or loss is realized, an office or other fixed place of business, as defined in § 1.864–7, to which such income, gain, or loss is attributable in accordance with § 1.864–6. The income of such person for the taxable year from sources without the United States which is specified in paragraph (c) of this section shall be treated as effectively connected for the taxable year with the conduct of a trade or business in the United States when derived by a foreign corporation carrying on a life insurance business in the United States. Except as provided in paragraphs (b) and (c) of this section, no income, gain, or loss of a nonresident alien individual or a foreign corporation for the taxable year from sources without the United States shall be treated as effectively connected for the taxable year with the conduct of a trade or business in the United States by that person. Any income, gain, or loss described in paragraph (b) or (c) of this section which, if it were derived by the taxpayer from sources within the United States for the taxable year, would not be treated under § 1.864–4 as effectively connected for the taxable year with the conduct of a trade or business in the United States shall not be treated under this section as effectively connected for the taxable year with the conduct of a trade or business in the United States.

(b) *Income other than income attributable to U.S. life insurance business.* Income, gain, or loss from sources without the United States other than income described in paragraph (c) of this section shall be taken into account pursuant to paragraph (a) of this section in applying §§ 1.864–6 and 1.864–7 only if it consists of—

(1) *Rents, royalties, or gains on sales of intangible property.* (i) Rents or royalties for the use of, or for the privilege of using, intangible personal property located outside the United States or from any interest in such property, including rents or royalties for the use, or for the privilege of using, outside the United States, patents, copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises, and other like properties, if such rents or royalties are derived in the active conduct of the trade or business in the United States.

(ii) Gains or losses on the sale or exchange of intangible personal property located outside the United States or from any interest in such property, including gains or losses on the sale or exchange of the privilege of using, outside the United States, patents, copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises, and other like properties, if such gains or losses are derived in the active conduct of the trade or business in the United States.

(iii) Whether or not such an item of income, gain, or loss is derived in the active conduct of a trade or business in the United States shall be determined from the facts and circumstances of each case. The frequency with which a nonresident alien individual or a foreign corporation enters into transactions of the type from which the income, gain, or loss is derived shall not of itself determine that the income, gain, or loss is derived in the active conduct of a trade or business.

(iv) This subparagraph shall not apply to rents or royalties for the use of, or for the privilege of using, real property or tangible personal property,

or to gain or loss from the sale or exchange of such property.

(2) *Dividends or interest, or gains or loss from sales of stocks or securities*—(i) *In general.* Dividends or interests from any transaction, or gains or losses on the sale or exchange of stocks or securities, realized by (*a*) a nonresident alien individual or a foreign corporation in the active conduct of a banking, financing, or similar business in the United States or (*b*) a foreign corporation engaged in business in the United States whose principal business is trading in stocks or securities for its own account. Whether the taxpayer is engaged in the active conduct of a banking, financing, or similar business in the United States for purposes of this subparagraph shall be determined in accordance with the principles of paragraph (c)(5)(i) of § 1.864–4.

(ii) *Substitute payments.* For purposes of this paragraph (b)92), a substitute interest payment (as defined in § 1.861–2(a)(7)) received by a foreign person subject to tax under this paragraph (b) pursuant to a securities lending transaction or a sale-repurchase transaction (as defined in § 1.861–2(a)(7)) with respect to a security (as defined in § 1.864–6(b)(2)(ii)(c)) shall have the same character as interest income paid or accrued with respect to the terms of the transferred security. Similarly, for purposes of this paragraph (b)(2), a substitute dividend payment (as defined in § 1.861–3(a)(6)) received by a foreign person pursuant to a securities lending transaction or a sale-repurchase transaction (as defined in § 1.861–3(a)(6)) with respect to a stock shall have the same character as a distribution with respect to the transferred security. This paragraph (b)(2)(ii) is applicable to payments made after November 13, 1997.

(iii) *Incidental investment activity.* This subparagraph shall not apply to income, gain, or loss realized by a nonresident alien individual or foreign corporation on stocks or securities held, sold, or exchanged in connection with incidental investment activities carried on by that person. Thus, a foreign corporation which is primarily a holding company owning significant percentages of the stocks or securities issued by other corporations shall not be treated under this subparagraph as a corporation the principal business of which is trading in stocks or securities for its own account, solely because it engages in sporadic purchases or sales of stocks or securities to adjust its portfolio. The application of this subdivision may be illustrated by the following example:

Example. F, a foreign corporation, owns voting stock in foreign corporations M, N, and P, its holdings in such corporations constituting 15, 20, and 100 percent, respectively, of all classes of their outstanding voting stock. Each of such stock holdings by F represents approximately 20 percent of its total assets. The remaining 40 percent of F's assets consist of other investments, 20 percent being invested in securities issued by foreign governments and in stocks and bonds issued by other corporations in which F does not own a significant percentage of their outstanding voting stock, and 20 percent being invested in bonds issued by N. None of the assets of F are held primarily for sale; but if the officers of that corporation were to decide that other investments would be preferable to its holding of such assets, F would sell the stocks and securities and reinvest the proceeds therefrom in other holdings. Any income, gain, or loss which F may derive from this investment activity is not considered to be realized by a foreign corporation described in subdivision (i) of this subparagraph.

(3) *Sale of goods or merchandise through U.S. office.* (i) Income, gain, or loss from the sale of inventory items or of property held primarily for sale to customers in the ordinary course of business, as described in section 1221(1), where the sale is outside the United States but through the office or other fixed place of business which the nonresident alien or foreign corporation has in the United States, irrespective of the destination to which such property is sent for use, consumption, or disposition.

(ii) This subparagraph shall not apply to income, gain, or loss resulting from a sales contract entered into on or before February 24, 1966. See section 102(e)(1) of the Foreign Investors Tax Act of 1966 (80 Stat. 1547). Thus, for example, the sales office in the United States of a foreign corporation enters into negotiations for the sale of 500,000 industrial bearings which the corporation produces in a foreign country for consumption in the Western Hemisphere. These negotiations culminate

in a binding agreement entered into on January 1, 1966. By its terms delivery under the contract is to be made over a period of 3 years beginning in March of 1966. Payment is due upon delivery. The income from sources without the United States resulting from this sale negotiated by the U.S. sales office of the foreign corporation shall not be taken into account under this subparagraph for any taxable year.

(iii) This subparagraph shall not apply to gains or losses on the sale or exchange of intangible personal property to which subparagraph (1) of this paragraph applies or of stocks or securities to which subparagraph (2) of this paragraph applies.

(c) *Income attributable to U.S. life insurance business.* (1) All of the income for the taxable year of a foreign corporation described in subparagraph (2) of this paragraph from sources without the United States, which is attributable to its U.S. life insurance business, shall be treated as effectively connected for the taxable year with the conduct of a trade or business in the United States by that corporation. Thus, in determining its life insurance company taxable income from its U.S. business for purposes of section 802, the foreign corporation shall include all of its items of income from sources without the United States which would appropriately be taken into account in determining the life insurance company taxable income of a domestic corporation. The income to which this subparagraph applies shall be taken into account for purposes of paragraph (a) of this section without reference to §§ 1.864–6 and 1.864–7.

(2) A foreign corporation to which subparagraph (1) of this paragraph applies is a foreign corporation carrying on an insurance business in the United States during the taxable year which—

(i) Without taking into account its income not effectively connected for that year with the conduct of any trade or business in the United States, would qualify as a life insurance company under part I (section 801 and following) of subchapter L, chapter 1 of the Code, if it were a domestic corporation, and

(ii) By reason of section 842 is taxable under that part on its income which is effectively connected for that year with its conduct of any trade or business in the United States.

(d) *Excluded foreign source income.* Notwithstanding paragraphs (b) and (c) of this section, no income from sources without the United States shall be treated as effectively connected for any taxable year with the conduct of a trade or business in the United States by a nonresident alien individual or a foreign corporation if the income consists of—

(1) *Dividends, interest, or royalties paid by a related foreign corporation.* Dividends, interest, or royalties paid by a foreign corporation in which the nonresident alien individual or the foreign corporation described in paragraph (a) of this section owns, within the meaning of section 958(a), or is considered as owning, by applying the ownership rules of section 958(b), at the time such items are paid more than 50 percent of the total combined voting power of all classes of stock entitled to vote.

(2) *Subpart F income of a controlled foreign corporation.* Any income of the foreign corporation described in paragraph (a) of this section which is subpart F income for the taxable year, as determined under section 952(a), even though part of the income is attributable to amounts which, if distributed by the foreign corporation, would be distributed with respect to its stock which is owned by shareholders who are not U.S. shareholders within the meaning of section 951(b). This subparagraph shall not apply to any income of the foreign corporation which is excluded in determining its subpart F income for the taxable year for purposes of section 952(a). Thus, for example, this subparagraph shall not apply to—

(i) Foreign base company shipping income which is excluded under section 954(b)(2),

(ii) Foreign base company income amounting to less than 10 percent (30 percent in the case of taxable years of foreign corporations ending before January 1, 1976) of gross income which by reason of section 954(b)(3)(A) does not become subpart F income for the taxable year,

(iii) Any income excluded from foreign base company income under section 954(b)(4), relating to exception for

foreign corporations not availed of to reduce taxes,

(iv) Any income derived in the active conduct of a trade or business which is excluded under section 954(c)(3), or

(v) Any income received from related persons which is excluded under section 954(c)(4).

This subparagraph shall apply to the foreign corporation's entire subpart F income for the taxable year determined under section 952(a), even though no amount is included in the gross income of a U.S. shareholder under section 951(a) with respect to that subpart F income because of the minimum distribution provisions of section 963(a) or because of the reduction under section 970(a) with respect to an export trade corporation. This subparagraph shall apply only to a foreign corporation which is a controlled foreign corporation within the meaning of section 957 and the regulations thereunder. The application of this subparagraph may be illustrated by the following examples:

Example 1. Controlled foreign corporation M, incorporated under the laws of foreign country X, is engaged in the business of purchasing and selling merchandise manufactured in foreign country Y by an unrelated person. M negotiates sales, through its sales office in the United States, of its merchandise for use outside of country X. These sales are made outside the United States, and the merchandise is sold for use outside the United States. No office maintained by M outside the United States participates materially in the sales made through its U.S. sales office. These activities constitute the only activities of M. During the taxable year M derives $100,000 income from these sales made through its U.S. sales office, and all of such income is foreign base company sales income by reason of section 954(d)(2) and paragraph (b) of §1.954–3. The entire $100,000 is also subpart F income, determined under section 952(a). In addition, all of this income would, without reference to section 864(c)(4)(D)(ii) and this subparagraph, be treated as effectively connected for the taxable year with the conduct of a trade or business in the United States by M. Through its entire taxable year 60 percent of the one class of stock of M is owned within the meaning of section 958(a) by U.S. shareholders, as defined in section 951(b), and 40 percent of its one class of stock is owned within the meaning of section 958(a) by persons who are not U.S. shareholders, as defined in section 951(b). Although only $60,000 of the subpart F income of M for the taxable year is includible in the income of the U.S. shareholders under section 951(a), the entire subpart F income of $100,000 constitutes income which, by reason of section 864(c)(4)(D)(ii) and this subparagraph, is not effectively connected for the taxable year with the conduct of a trade or business in the United States by M.

Example 2. The facts are the same as in example 1 except that the foreign base company sales income amounts to $150,000 determined in accordance with paragraph (d)(3)(i) of §1.954–1, and that M also has gross income from sources without the United States of $50,000 from sales, through its sales office in the United States, of merchandise for use in country X. These sales are made outside the United States. All of this income would, without reference to section 864(c)(4)(D)(ii) and this subparagraph, be treated as effectively connected for the taxable year with the conduct of a trade or business in the United States by M. Since the foreign base company income of $150,000 amounts to 75 percent of the entire gross income of $200,000, determined as provided in paragraph (d)(3)(ii) of §1.954–1, the entire $200,000 constitutes foreign base company income under section 954(b)(3)(B). Assuming that M has no amounts to be taken into account under paragraphs (1), (2), (4), and (5) of section 954(b), the $200,000 is also subpart F income, determined under section 952(a). This subpart F income of $200,000 constitutes income which, by reason of section 864(c)(4)(D)(ii) and this subparagraph, is not effectively connected for the taxable year with the conduct of a trade or business in the United States by M.

(3) *Interest on certain deposits.* Interest which, by reason of section 861(a)(1)(A) (relating to interest on deposits with banks, savings and loan associations, and insurance companies paid or credited before January 1, 1976) and paragraph (c) of §1.864–4, is determined to be income from sources without the United States because it is not effectively connected for the taxable year with the conduct of a trade or business in the United States by the nonresident alien individual or foreign corporation.

[T.D. 7216, 37 FR 23429, Nov. 3, 1972, as amended by T.D. 7893, 48 FR 22507, May 19, 1983; T.D. 8735, 62 FR 53501, Oct. 14, 1997]

§ 1.864–6 Income, gain, or loss attributable to an office or other fixed place of business in the United States.

(a) *In general.* Income, gain, or loss from sources without the United States which is specified in paragraph (b) of § 1.864–5 and received by a nonresident alien individual or a foreign corporation engaged in a trade or business in the United States at some time during a taxable year beginning after December 31, 1966, shall be treated as effectively connected for the taxable year with the conduct of a trade or business in the United States only if the income, gain, or loss is attributable under paragraphs (b) and (c) of this section to an office or other fixed place of business, as defined in § 1.864–7, which the taxpayer has in the United States at some time during the taxable year.

(b) *Material factor test*—(1) *In general.* For purposes of paragraph (a) of this section, income, gain, or loss is attributable to an office or other fixed place of business which a nonresident alien individual or a foreign corporation has in the United States only if such office or other fixed place of business is a material factor in the realization of the income, gain, or loss, and if the income, gain, or loss is realized in the ordinary course of the trade or business carried on through that office or other fixed place of business. For this purpose, the activities of the office or other fixed place of business shall not be considered to be a material factor in the realization of the income, gain, or loss unless they provide a significant contribution to, by being an essential economic element in, the realization of the income, gain, or loss. Thus, for example, meetings in the United States of the board of directors of a foreign corporation do not of themselves constitute a material factor in the realization of income, gain, or loss. It is not necessary that the activities of the office or other fixed place of business in the United States be a major factor in the realization of the income, gain, or loss. An office or other fixed place of business located in the United States at some time during a taxable year may be a material factor in the realization of an item of income, gain, or loss for that year even though the office or other fixed place of business is not present in the United States when the income, gain, or loss is realized.

(2) *Application of material factor test to specific classes of income.* For purposes of paragraph (a) of this section, an office or other fixed place of business which a nonresident alien individual or a foreign corporation, engaged in a trade or business in the United States at some time during the taxable year, had in the United States, shall be considered a material factor in the realization of income, gain, or loss consisting of—

(i) *Rents, royalties, or gains on sales of intangible property.* Rents, royalties, or gains or losses, from intangible personal property specified in paragraph (b)(1) of § 1.864–5, if the office or other fixed place of business either actively participates in soliciting, negotiating, or performing other activities required to arrange, the lease, license, sale, or exchange from which such income, gain, or loss is derived or performs significant services incident to such lease, license, sale, or exchange. An office or other fixed place of business in the United States shall not be considered to be a material factor in the realization of income, gain, or loss for purposes of this subdivision merely because the office or other fixed place of business conducts one or more of the following activities: (*a*) Develops, creates, produces, or acquires and adds substantial value to, the property which is leased, licensed, or sold, or exchanged, (*b*) collects or accounts for the rents, royalties, gains, or losses, (*c*) exercises general supervision over the activities of the persons directly responsible for carrying on the activities or services described in the immediately preceding sentence, (*d*) performs merely clerical functions incident to the lease, license, sale, or exchange or (*e*) exercises final approval over the execution of the lease, license, sale, or exchange. The application of this subdivision may be illustrated by the following examples:

Example 1. F, a foreign corporation, is engaged in the active conduct of the business of licensing patents which it has either purchased or developed in the United States. F has a business office in the United States. Licenses for the use of such patents outside

the United States are negotiated by offices of F located outside the United States, subject to approval by an officer of such corporation located in the U.S. office. All services which are rendered to F's foreign licensees are performed by employees of F's offices located outside the United States. None of the income, gain, or loss resulting from the foreign licenses so negotiated by F is attributable to its business office in the United States.

Example 2. N, a foreign corporation, is engaged in the active conduct of the business of distributing motion picture films and television programs. N does not distribute such films or programs in the United States. The foreign distribution rights to these films and programs are acquired by N's U.S. business office from the U.S. owners of these films and programs. Employees of N's offices located in various foreign countries carry on in such countries all the solicitations and negotiations for the licensing of these films and programs to licensees located in such countries and provide the necessary incidental services to the licensees. N's U.S. office collects the rentals from the foreign licensees and maintains the necessary records of income and expense. Officers of N located in the United States also maintain general supervision over the employees of the foreign offices, but the foreign employees conduct the day to day business of N outside the United States of soliciting, negotiating, or performing other activities required to arrange the foreign licenses. None of the income, gain, or loss resulting from the foreign licenses so negotiated by N is attributable to N's U.S. office.

(ii) *Dividends or interest, or gains or losses from sales of stock or securities—(a) In general.* Dividends or interest from any transaction, or gains or losses on the sale or exchange of stocks or securities, specified in paragraph (b)(2) of §1.864–5, if the office or other fixed place of business either actively participates in soliciting, negotiating, or performing other activities required to arrange, the issue, acquisition, sale, or exchange, of the asset from which such income, gain, or loss is derived or performs significant services incident to such issue, acquisition, sale, or exchange. An office or other fixed place of business in the United States shall not be considered to be a material factor in the realization of income, gain, or loss for purposes of this subdivision merely because the office or other fixed place of business conducts one or more of the following activities: (*1*) Collects or accounts for the dividends, interest, gains, or losses, (*2*) exercises general supervision over the activities of the persons directly responsible for carrying on the activities or services described in the immediately preceding sentence, (*3*) performs merely clerical functions incident to the issue, acquisition, sale, or exchange, or (*4*) exercises final approval over the execution of the issue, acquisition, sale, or exchange.

(*b*) *Effective connection of income from stocks or securities with active conduct of a banking, financing, or similar business.* Notwithstanding (*a*) of this subdivision (ii), the determination as to whether any dividends or interest from stocks or securities, or gain or loss from the sale or exchange of stocks or securities which are capital assets, which is from sources without the United States and derived by a nonresident alien individual or a foreign corporation in the active conduct during the taxable year of a banking, financing, or similar business in the United States, shall be treated as effectively connected for such year with the active conduct of that business shall be made by applying the principles of paragraph (c)(5)(ii) of §1.864–4 for determining whether income, gain, or loss of such type from sources within the United States is effectively connected for such year with the active conduct of that business.

(*c*) *Security defined.* For purposes of this subdivision (ii), a security is any bill, note, bond, debenture, or other evidence of indebtedness, or any evidence of an interest in, or right to subscribe or to purchase, any of the foregoing items.

(*d*) *Limitations on application of rules on banking, financing, or similar business—(1) Trading for taxpayer's own account.* The provisions of (*b*) of this subdivision (ii) apply for purposes of determining when certain income, gain, or loss from stocks or securities is effectively connected with the active conduct of a banking, financing, or similar business in the United States. Any dividends, interest, gain, or loss from sources without the United States which by reason of the application of (*b*) of this subdivision (ii) is not effectively connected with the active conduct by a foreign corporation of a banking, financing, or similar business in the United States may be effectively

connected for the taxable year, under (*a*) of this subdivision (ii), with the conduct by such taxpayer of a trade or business in the United States which consists of trading in stocks or securities for the taxpayer's own account.

(*2*) *Other income.* For rules relating to dividends or interest from sources without the United States (other than dividends or interest from, or gain or loss from the sale or exchange of, stocks or securities referred to in (*b*) of this subdivision (ii)) derived in the active conduct of a banking, financing, or similar business in the United States, see (*a*) of this subdivision (ii).

(iii) *Sale of goods or merchandise through U.S. office.* Income, gain, or loss from sales of goods or merchandise specified in paragraph (b)(3) of §1.864–5, if the office or other fixed place of business actively participates in soliciting the order, negotiating the contract of sale, or performing other significant services necessary for the consummation of the sale which are not the subject of a separate agreement between the seller and the buyer. The office or other fixed place of business in the United States shall be considered a material factor in the realization of income, gain, or loss from a sale made as a result of a sales order received in such office or other fixed place of business except where the sales order is received unsolicited and that office or other fixed place of business is not held out to potential customers as the place to which such sales orders should be sent. The income, gain, or loss must be realized in the ordinary course of the trade or business carried on through the office or other fixed place of business in the United States. Thus, if a foreign corporation is engaged solely in a manufacturing business in the United States, the income derived by its office in the United States as a result of an occasional sale outside the United States is not attributable to the U.S. office if the sales office of the manufacturing business is located outside the United States. On the other hand, if a foreign corporation establishes a sales office in the United States to sell for consumption in the Western Hemisphere merchandise which the corporation produces in Africa, the income derived by the sales office in the United States as a result of an occasional sale made by it in Europe shall be attributable to the U.S. sales office. An office or other fixed place of business in the United States shall not be considered to be a material factor in the realization of income, gain, or loss for purposes of this subdivision merely because of one or more of the following activities: (*a*) The sale is made subject to the final approval of such office or other fixed place of business, (*b*) the property sold is held in, and distributed from, such office or other fixed place of business, (*c*) samples of the property sold are displayed (but not otherwise promoted or sold) in such office or other fixed place of business, or (*d*) such office or other fixed place of business performs merely clerical functions incident to the sale. Activities carried on by employees of an office or other fixed place of business constitute activities of that office or other fixed place of business.

(3) *Limitation where foreign office is a material factor in realization of income*—(i) *Goods or merchandise destined for foreign use, consumption, or disposition.* Notwithstanding subparagraphs (1) and (2) of this paragraph, an office or other fixed place of business which a nonresident alien individual or a foreign corporation has in the United States shall not be considered, for purposes of paragraph (a) of this section, to be a material factor in the realization of income, gain, or loss from sales of goods or merchandise specified in paragraph (b)(3) of §1.864–5 if the property is sold for use, consumption, or disposition outside the United States and an office or other fixed place of business, as defined in §1.864–7, which such nonresident alien individual or foreign corporation has outside the United States participates materially in the sale. For this purpose an office or other fixed place of business which the taxpayer has outside the United States shall be considered to have participated materially in a sale made through the office or other fixed place of business in the United States if the office or other fixed place of business outside the United States actively participates in soliciting the order resulting in the sale, negotiating the contract of sale,

or performing other significant services necessary for the consummation of the sale which are not the subject of a separate agreement between the seller and buyer. An office or other fixed place of business which the taxpayer has outside the United States shall not be considered to have participated materially in a sale merely because of one or more of the following activities: (*a*) The sale is made subject to the final approval of such office or other fixed place of business, (*b*) the property sold is held in, and distributed from, such office or other fixed place of business, (*c*) samples of the property sold are displayed (but not otherwise promoted or sold) in such office or other fixed place of business, (*d*) such office or other fixed place of business is used for purposes of having title to the property pass outside the United States, or (*e*) such office or other fixed place of business performs merely clerical functions incident to the sale.

(ii) *Rules for determining country of use, consumption, or disposition—(a) In general.* As a general rule, personal property which is sold to an unrelated person shall be presumed for purposes of this subparagraph to have been sold for use, consumption, or disposition in the country of destination of the property sold; for such purpose, the occurrence in a country of a temporary interruption in shipment of property shall not cause that country to be considered the country of destination. However, if at the time of a sale of personal property to an unrelated person the taxpayer knew, or should have known from the facts and circumstances surrounding the transaction, that the property probably would not be used, consumed, or disposed of in the country of destination, the taxpayer must determine the country of ultimate use, consumption, or disposition of the property or the property shall be presumed to have been sold for use, consumption, or disposition in the United States. A taxpayer who sells personal property to a related person shall be presumed to have sold the property for use, consumption, or disposition in the United States unless the taxpayer establishes the use made of the property by the related person; once he has established that the related person has disposed of the property, the rules in the two immediately preceding sentences relating to sales to an unrelated person shall apply at the first stage in the chain of distribution at which a sale is made by a related person to an unrelated person. Notwithstanding the preceding provisions of this subdivision (*a*), a taxpayer who sells personal property to any person whose principal business consists of selling from inventory to retail customers at retail outlets outside the United States may assume at the time of the sale to that person that the property will be used, consumed, or disposed of outside the United States. For purposes of this (*a*), a person is related to another person if either person owns or controls directly or indirectly the other, or if any third person or persons own or control directly or indirectly both. For this purpose, the term ''control'' includes any kind of control, whether or not legally enforceable, and however, exercised or exercisable. For illustrations of the principles of this subdivision, see paragraph (a)(3)(iv) of § 1.954–3.

(*b*) *Fungible goods.* For purposes of this subparagraph, a taxpayer who sells to a purchaser personal property which because of its fungible nature cannot reasonably be specifically traced to other purchasers and to the countries of ultimate use, consumption, or disposition shall, unless the taxpayer establishes a different disposition as being proper, treat that property as being sold, for ultimate use, consumption, or disposition in those countries, and to those other purchasers, in the same proportions in which property from the fungible mass of the first purchaser is sold in the ordinary course of business by such first purchaser. No apportionment is required to be made, however, on the basis of sporadic sales by the first purchaser. This (*b*) shall apply only in a case where the taxpayer knew, or should have known from the facts and circumstances surrounding the transaction, the manner in which the first purchaser disposes of property from the fungible mass.

(iii) *Illustration.* The application of this subparagraph may be illustrated by the following example:

Example. Foreign corporation M has a sales office in the United States during the taxable year through which it sells outside the United States for use in foreign countries industrial electrical generators which such corporation manufactures in a foreign country. M is not a controlled foreign corporation within the meaning of section 957 and the regulations thereunder, and, by reason of its activities in the United States, is engaged in business in the United States during the taxable year. The generators require specialized installation and continuous adjustment and maintenance services. M has an office in foreign country X which is the only organization qualified to perform these installation, adjustment, and maintenance services. During the taxable year M sells several generators through its U.S. office for use in foreign country Y under sales contracts which also provide for installation, adjustment, and maintenance by its office in country X. The generators are installed in country Y by employees of M's office in country X, who also are responsible for the servicing of the equipment. Since the office of M in country X performs significant services incident to these sales which are necessary for their consummation and are not the subject of a separate agreement between M and the purchaser, the U.S. office of M is not considered to be a material factor in the realization of the income from the sales and, for purposes of paragraph (a) of this section, such income is not attributable to the U.S. office of that corporation.

(c) *Amount of income, gain, or loss allocable to U.S. office*—(1) *In general*. If, in accordance with paragraph (b) of this section, an office or other fixed place of business which a nonresident alien individual or a foreign corporation has in the United States at some time during the taxable year is a material factor in the realization for that year of an item of income, gain, or loss specified in paragraph (b) of §1.864–5, such item of income, gain, or loss shall be considered to be allocable in its entirety to that office or other fixed place of business. In no case may any income, gain, or loss for the taxable year from sources without the United States, or part thereof, be allocable under this paragraph to an office or other fixed place of business which a nonresident alien individual or a foreign corporation has in the United States if the taxpayer is at no time during the taxable year engaged in a trade or business in the United States.

(2) *Special limitation in case of sales of goods or merchandise through U.S. office*. Notwithstanding subparagraph (1) of this paragraph, in the case of a sale of goods or merchandise specified in paragraph (b)(3) of §1.864–5, which is not a sale to which paragraph (b)(3)(i) of this section applies, the amount of income which shall be considered to be allocable to the office or other fixed place of business which the nonresident alien individual or foreign corporation has in the United States shall not exceed the amount which would be treated as income from sources within the United States if the taxpayer had sold the goods or merchandise in the United States. See, for example, section 863(b)(2) and paragraph (b) of §1.863–3, which prescribes, as available methods for determining the income from sources within the United States, the independent factory or production price method, the gross sales and property apportionment method, and any other method regularly employed by the taxpayer which more clearly reflects taxable income from such sources than those specifically authorized.

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

Example 1. Foreign corporation M, which is not a controlled foreign corporation within the meaning of section 957 and the regulations thereunder, manufactures machinery in a foreign country and sells the machinery outside the United States through its sales office in the United States for use in foreign countries. Title to the property which is sold is transferred to the foreign purchaser outside the United States, but no office or other fixed place of business of M in a foreign country participates materially in the sale made through its U.S. office. During the taxable year M derives a total taxable income (determined as though M were a domestic corporation) of $250,000 from these sales. If the sales made through the U.S. office for the taxable year had been made in the United States and the property had been sold for use in the United States, the taxable income from sources within the United States from such sales would have been $100,000, determined as provided in section 863 and 882(c) and the regulations thereunder. The taxable income which is allocable to M's U.S. sales office pursuant to this paragraph and which is effectively connected for the taxable year with the conduct of a trade or business within the United States by that corporation is $100,000.

Example 2. Foreign corporation N, which is not a controlled foreign corporation within the meaning of section 957 and the regulations thereunder, has an office in a foreign country which purchases merchandise and sells it through its sales office in the United States for use in various foreign countries, such sales being made outside the United States and title to the property passing outside the United States. No other office of N participates materially in these sales made through its U.S. office. By reason of its sales activities in the United States, N is engaged in business in the United States during the taxable year. During the taxable year N derives taxable income (determined as though N were a domestic corporation) of $300,000 from these sales made through its U.S. sales office. If the sales made through the U.S. office for the taxable year had been made in the United States and the property had been sold for use in the United States, the taxable income from sources within the United States from such sales would also have been $300,000, determined as provided in sections 861 and 882(c) and the regulations thereunder. The taxable income which is allocable to N's U.S. sales office pursuant to this paragraph and which is effectively connected for the taxable year with the conduct of a trade or business in the United States by that corporation is $300,000.

Example 3. The facts are the same as in example 2, except that N has an office in a foreign country which participates materially in the sales which are made through its U.S. office. The taxable income which is allocable to N's U.S. sales office is not effectively connected for the taxable year with the conduct of a trade or business in the United States by that corporation.

[T.D. 7216, 37 FR 23431, Nov. 3, 1972]

§ 1.864–7 Definition of office or other fixed place of business.

(a) *In general.* (1) This section applies for purposes of determining whether a nonresident alien individual or a foreign corporation that is engaged in a trade or business in the United States at some time during a taxable year beginning after December 31, 1966, has an office or other fixed place of business in the United States for purposes of applying section 864(c)(4)(B) and § 1.864–6 to income, gain, or loss specified in paragraph (b) of § 1.864–5 from sources without the United States or has an office or other fixed place of business outside the United States for purposes of applying section 864(c)(4)(B)(iii) and paragraph (b)(3)(i) of § 1.864–6 to sales of goods or merchandise for use, consumption, or disposition outside the United States.

(2) In making a determination under this section due regard shall be given to the facts and circumstances of each case, particularly to the nature of the taxpayer's trade or business and the physical facilities actually required by the taxpayer in the ordinary course of the conduct of his trade or business.

(3) The law of a foreign country shall not be controlling in determining whether a nonresident alien individual or a foreign corporation has an office or other fixed place of business.

(b) *Fixed facilities*—(1) *In general.* As a general rule, an office or other fixed place of business is a fixed facility, that is, a place, site, structure, or other similar facility, through which a nonresident alien individual or a foreign corporation engages in a trade or business. For this purpose an office or other fixed place of business shall include, but shall not be limited to, a factory; a store or other sales outlet; a workshop; or a mine, quarry, or other place of extraction of natural resources. A fixed facility may be considered an office or other fixed place of business whether or not the facility is continuously used by a nonresident alien individual or foreign corporation.

(2) *Use of another person's office or other fixed place of business.* A nonresident alien individual or a foreign corporation shall not be considered to have an office or other fixed place of business merely because such alien individual or foreign corporation uses another person's office or other fixed place of business, whether or not the office or place of business of a related person, through which to transact a trade or business, if the trade or business activities of the alien individual or foreign corporation in that office or other fixed place of business are relatively sporadic or infrequent, taking into account the overall needs and conduct of that trade or business.

(c) *Management activity.* A foreign corporation shall not be considered to have an office or other fixed place of business merely because a person controlling that corporation has an office or other fixed place of business from which general supervision and control

over the policies of the foreign corporation are exercised. The fact that top management decisions affecting the foreign corporation are made in a country shall not of itself mean that the foreign corporation has an office or other fixed place of business in that country. For example, a foreign sales corporation which is a wholly owned subsidiary of a domestic corporation shall not be considered to have an office or other fixed place of business in the United States merely because of the presence in the United States of officers of the domestic parent corporation who are generally responsible only for the policy decisions affecting the foreign sales corporation, provided that the foreign corporation has a chief executive officer, whether or not he is also an officer of the domestic parent corporation, who conducts the day-to-day trade or business of the foreign corporation from a foreign office. The result in this example would be the same even if the executive officer should (1) regularly confer with the officers of the domestic parent corporation, (2) occasionally visit the U.S. office of the domestic parent corporation, and (3) during such visits to the United States temporarily conduct the business of the foreign subsidiary corporation out of the domestic parent corporation's office in the United States.

(d) *Agent activity*—(1) *Dependent agents*—(i) *In general*. In determining whether a nonresident alien individual or a foreign corporation has an office or other fixed place of business, the office or other fixed place of business of an agent who is not an independent agent, as defined in subparagraph (3) of this paragraph, shall be disregarded unless such agent (*a*) has the authority to negotiate and conclude contracts in the name of the nonresident alien individual or foreign corporation, and regularly exercises that authority, or (*b*) has a stock of merchandise belonging to the nonresident alien individual or foreign corporation from which orders are regularly filed on behalf of such alien individual or foreign corporation. A person who purchases goods from a nonresident alien individual or a foreign corporation shall not be considered to be an agent for such alien individual or foreign corporation for purposes of this paragraph where such person is carrying on such purchasing activities in the ordinary course of its own business, even though such person is related in some manner to the nonresident alien individual or foreign corporation. For example, a wholly owned domestic subsidiary corporation of a foreign corporation shall not be treated as an agent of the foreign parent corporation merely because the subsidiary corporation purchases goods from the foreign parent corporation and resells them in its own name. However, if the domestic subsidiary corporation regularly negotiates and concludes contracts in the name of its foreign parent corporation or maintains a stock of merchandise from which it regularly fills orders on behalf of the foreign parent corporation, the office or other fixed place of business of the domestic subsidiary corporation shall be treated as the office or other fixed place of business of the foreign parent corporation unless the domestic subsidiary corporation is an independent agent within the meaning of subparagraph (3) of this paragraph.

(ii) *Authority to conclude contracts or fill orders*. For purposes of subdivision (i) of this subparagraph, an agent shall be considered regularly to exercise authority to negotiate and conclude contracts or regularly to fill orders on behalf of his foreign principal only if the authority is exercised, or the orders are filled, with some frequency over a continuous period of time. This determination shall be made on the basis of the facts and circumstances in each case, taking into account the nature of the business of the principal; but, in all cases, the frequency and continuity tests are to be applied conjunctively. Regularity shall not be evidenced by occasional or incidental activity. An agent shall not be considered regularly to negotiate and conclude contracts on behalf of his foreign principal if the agent's authority to negotiate and conclude contracts is limited only to unusual cases or such authority must be separately secured by the agent from his principal with respect to each transaction effected.

(2) *Independent agents.* The office or other fixed place of business of an independent agent, as defined in subparagraph (3) of this paragraph, shall not be treated as the office or other fixed place of business of his principal who is a nonresident alien individual or a foreign corporation, irrespective of whether such agent has authority to negotiate and conclude contracts in the name of his principal, and regularly exercises that authority, or maintains a stock of goods from which he regularly fills orders on behalf of his principal.

(3) *Definition of independent agent*—(i) *In general.* For purposes of this paragraph, the term ''independent agent'' means a general commission agent, broker, or other agent of an independent status acting in the ordinary course of his business in that capacity. Thus, for example, an agent who, in pursuance of his usual trade or business, and for compensation, sells goods or merchandise consigned or entrusted to his possession, management, and control for that purpose by or for the owner of such goods or merchandise is an independent agent.

(ii) *Related persons.* The determination of whether an agent is an independent agent for purposes of this paragraph shall be made without regard to facts indicating that either the agent or the principal owns or controls directly or indirectly the other or that a third person or persons own or control directly or indirectly both. For example, a wholly owned domestic subsidiary corporation of a foreign corporation which acts as an agent for the foreign parent corporation may be treated as acting in the capacity of independent agent for the foreign parent corporation. The facts and circumstances of a specific case shall determine whether the agent, while acting for his principal, is acting in pursuance of his usual trade or business and in such manner as to constitute him an independent agent in his relations with the nonresident alien individual or foreign corporation.

(iii) *Exclusive agents.* Where an agent who is otherwise an independent agent within the meaning of subdivision (i) of this subparagraph acts in such capacity exclusively, or almost exclusively, for one principal who is a nonresident alien individual or a foreign corporation, the facts and circumstances of a particular case shall be taken into account in determining whether the agent, while acting in that capacity, may be classified as an independent agent.

(e) *Employee activity.* Ordinarily, an employee of a nonresident alien individual or a foreign corporation shall be treated as a dependent agent to whom the rules of paragraph (d)(1) of this section apply if such employer does not in and of itself have a fixed facility (as defined in paragraph (b) of this section) in the United States or outside the United States, as the case may be. However, where the employee, in the ordinary course of his duties, carries on the trade or business of his employer in or through a fixed facility of such employer which is regularly used by the employee in the course of carrying out such duties, such fixed facility shall be considered the office or other fixed place of business of the employer, irrespective of the rules of paragraph (d)(1) of this section. The application of this paragraph may be illustrated by the following example:

Example. M, a foreign corporation, opens a showroom office in the United States for the purpose of promoting its sales of merchandise which it purchases in foreign country X. The employees of the U.S. office, consisting of salesmen and general clerks, are empowered only to run the office, to arrange for the appointment of distributing agents for the merchandise offered by M, and to solicit orders generally. These employees do not have the authority to negotiate and conclude contracts in the name of M, nor do they have a stock of merchandise from which to fill orders on behalf of M. Any negotiations entered into by these employees are under M's instructions and subject to its approval as to any decision reached. The only independent authority which the employees have is in the appointment of distributors to whom M is to sell merchandise, but even this authority is subject to the right of M to approve or disapprove these buyers on receipt of information as to their business standing. Under the circumstances, this office used by a group of salesmen for sales promotion is a fixed place of business which M has in the United States.

(f) *Office or other fixed place of business of a related person.* The fact that a nonresident alien individual or a foreign corporation is related in some

manner to another person who has an office or other fixed place of business shall not of itself mean that such office or other fixed place of business of the other person is the office or other fixed place of business of the nonresident alien individual or foreign corporation. Thus, for example, the U.S. office of foreign corporation M, a wholly owned subsidiary corporation of foreign corporation N, shall not be considered the office or other fixed place of business of N unless the facts and circumstances show that N is engaged in trade or business in the United States through that office or other fixed place of business. However, see paragraph (b)(2) of this section.

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

Example 1. S, a foreign corporation, is engaged in the business of buying and selling tangible personal property. S is a wholly owned subsidiary of P, a domestic corporation engaged in the business of buying and selling similar property, which has an office in the United States. Officers of P are generally responsible for the policies followed by S and are directors of S, but S has an independent group of officers, none of whom are regularly employed in the United States. In addition to this group of officers, S has a chief executive officer, D, who is also an officer of P but who is permanently stationed outside the United States. The day-to-day conduct of S's business is handled by D and the other officers of such corporation, but they regularly confer with the officers of P and on occasion temporarily visit P's offices in the United States, at which time they continue to conduct the business of S. S does not have an office or other fixed place of business in the United States for purposes of this section.

Example 2. The facts are the same as in example 1 except that, on rare occasions, an employee of P receives an order which he, after consultation with officials of S and because P cannot fill the order, accepts on behalf of S rather than on behalf of P. P does not hold itself out as a person which those wishing to do business with S should contact. Assuming that orders for S are seldom handled in this manner and that they do not constitute a significant part of that corporation's business, S shall not be considered to have an office or other fixed place of business in the United States because of these activities of an employee of P.

Example 3. The facts are the same as in example 1 except that all orders received by S are subject to review by an officer of P before acceptance. S has a business office in the United States.

Example 4. S, a foreign corporation organized under the laws of Puerto Rico, is engaged in the business of manufacturing dresses in Puerto Rico and is entitled to an income tax exemption under the Puerto Rico Industrial Incentive Act of 1963. S is a wholly owned subsidiary of P, a domestic corporation engaged in the business of buying and selling dresses to customers in the United States. S sells most of the dresses it produces to P, the assumption being made that the income from these sales is derived from sources without the United States. P in turn sells these dresses in the United States in its name and through the efforts of its own employees and of distributors appointed by it. S does not have a fixed facility in the United States, and none of its employees are stationed in the United States. On occasion, employees of S visit the office of P in the United States, and executives of P visit the office of S in Puerto Rico, to discuss with one another matters of mutual business interest involving both corporations, including the strategy for marketing the dresses produced by S. These matters are also regularly discussed by such persons by telephone calls between the United States and Puerto Rico. S's employees do not otherwise participate in P's marketing activities. Officers of P are generally responsible for the policies followed by S and are directors of S, but S has a chief executive officer in Puerto Rico who, from its office therein, handles the day-to-day conduct of S's business. Based upon the facts presented, and assuming there are no other facts which would lead to a different determination, S shall not be considered to have an office or other fixed place of business in the United States for purposes of this section.

Example 5. The facts are the same as in example 4 except that the dresses are manufactured by S in styles and designs furnished by P and out of goods and raw materials purchased by P and sold to S. Based upon the facts presented, and assuming there are no other facts which would lead to a different determination, S shall not be considered to have an office or other fixed place of business in the United States for purposes of this section.

Example 6. The facts are the same as in example 5 except that, pursuant to the instructions of P, the dresses sold by P are shipped by S directly to P's customers in the United States. Based upon the facts presented, and assuming there are no other facts which would lead to a different determination, S shall not be considered to have an office or other fixed place of business in the United States for purposes of this section.

[T.D. 7216, 37 FR 23433, Nov. 3, 1972]

§ 1.864–8T Treatment of related person factoring income (temporary).

(a) *Applicability*—(1) *General rule.* This section applies for purposes of determining the treatment of income derived by a person from a trade or service receivable acquired from a related person. Except as provided in paragraph (d) of this section, if a person acquires (directly or indirectly) a trade or service receivable from a related person, any income (including any stated interest, discount or service fee) derived from the trade or service receivable shall be treated as if it were interest received on a loan to the obligor under the receivable. The characterization of income as interest pursuant to this section shall apply only for purposes of sections 551–558 (relating to foreign personal holding companies), sections 951–964 (relating to controlled foreign corporations), and section 904 (relating to the limitation on the foreign tax credit) of the Code and the regulations thereunder. The principles of sections 861 through 863 and the regulations thereunder shall be applied to determine the source of such interest income for purposes of section 904.

(2) *Override.* With respect to income characterized as interest under this section, the special rules of section 864(d) and this section override any conflicting provisions of the Code and regulations relating to foreign personal holding companies, controlled foreign corporations, and the foreign tax credit limitation. Thus, for example, pursuant to section 864(d)(5) and paragraph (e) of this section, stated interest derived from a factored trade or service receivable is not eligible for the subpart F de minimis rule of section 954(b)(3), the same country exception of section 954(c)(3)(A)(i), or the special rules for export financing interest of sections 904(d)(2) and 954(c)(2)(B), even if in the absence of this section the treatment of such stated interest would be governed by those sections.

(3) *Limitation.* Section 864(d) and this section apply only with respect to the tax treatment of income derived from a trade or service receivable acquired from a related person. Therefore, neither section 864(d) nor this section affects the characterization of an expense or loss of either the seller of a receivable or the obligor under a receivable. Accordingly, the obligor under a trade or service receivable shall not be allowed to treat any part of the purchase price of property or services as interest (other than amounts treated as interest under provisions other than section 864(d)).

(b) *Definitions.* The following definitions apply for purposes of this section and § 1.956–3T.

(1) *Trade or service receivable.* The term ''trade or service receivable'' means any account receivable or evidence of indebtedness, whether or not issued at a discount and whether or not bearing stated interest, arising out of the disposition by a related person of property described in section 1221(1) (hereinafter referred to as ''inventory property'') or the performance of services by a related person.

(2) *Related person.* A ''related person'' is:

(i) A person who is a related person within the meaning of section 267(b) and the regulations thereunder;

(ii) A United States shareholder (as defined in section 951(b)); or

(iii) A person who is related (within the meaning of section 267(b) and the regulations thereunder) to a United States shareholder.

(c) *Acquisition of a trade or service receivable*—(1) *General rule.* A trade or service receivable is considered to be acquired by a person at the time when that person is entitled to receive all or a portion of the income from the trade or service receivable. A person who acquires a trade or service receivable (hereinafter referred to as the ''factor'') is considered to have acquired a trade or service receivable regardless of whether:

(i) The acquisition is characterized for federal income tax purposes as a sale, a pledge of collateral for a loan, an assignment, a capital contribution, or otherwise;

(ii) The factor takes title to or obtains physical possession of the trade or service receivable;

(iii) The related person assigns the trade or service receivable with or without recourse:

(iv) The factor or some other person is obligated to collect the payments

due under the trade or service receivable;

(v) The factor is liable for all property, excise, sales, or similar taxes due upon collection of the receivable;

(vi) The factor advances the entire face amount of the trade or service receivable transferred;

(vii) All trade or service receivables assigned by the related person are assigned to one factor; and

(viii) The obligor under the trade or service receivable is notified of the assignment.

(2) *Example*. The following example illustrates the application of paragraphs (a), (b), and (c)(1) of this section.

Example. P, a domestic corporation, owns all of the outstanding stock of FS, a controlled foreign corporation. P manufactures and sells paper products to customers, including X, an unrelated domestic corporation. As part of a sales transaction, P takes back a trade receivable from X and sells the receivable to FS. Because FS has acquired a trade or service receivable from a related person, the income derived by FS from P's receivable is interest income described in paragraph (a)(1) of this section.

(3) *Indirect acquisitions*—(i) *Acquisition through unrelated person*. A trade or service receivable will be considered to be acquired from a related person if it is acquired from an unrelated person who acquired (directly or indirectly) such receivable from a person who is a related person to the factor. The following example illustrates the application of this paragraph (c)(3)(i).

Example. A, a United States citizen, owns all of the outstanding stock of FPHC, a foreign personal holding company. A performs engineering services within and without the United States for customers, including X, an unrelated corporation. A performs engineering services for X and takes back a service receivable. A sells the receivable to Y, an unrelated corporation engaged in the factoring business. Y resells the receivable to FPHC. Because FPHC has indirectly acquired a service receivable from a related person, the income derived by FPHC from A's receivable is interest income described in paragraph (a)(1) of this section.

(ii) *Acquisition by nominee or pass-through entity*. A factor will be considered to have acquired a trade or service receivable held on its behalf by a nominee or by a partnership, simple trust, S corporation or other pass-through entity to the extent the factor owns (directly or indirectly) a beneficial interest in such partnership or other pass-through entity. The rule of this paragraph (c)(3)(ii) does not limit the application of paragraph (c)(3)(iii) of this section regarding the characterization of trade or service receivables of unrelated persons acquired pursuant to certain swap or pooling arrangements. The following example illustrates the application of this paragraph (c)(3)(ii).

Example. FS1, a controlled foreign corporation, acquires a 20 percent limited partnership interest in PS, a partnership. PS purchases trade or service receivables resulting from the sale of inventory property by FS1's domestic parent, P. PS does not purchase receivables of any person who is related to any other partner in PS. FS1 is considered to have acquired a 20 percent interest in the receivables acquired by PS. Thus, FS1's distributive share of the income derived by PS from the receivables of P is considered to be interest income described in paragraph (a)(1) of this section.

(iii) *Swap or pooling arrangements*. A trade or service receivable of a person unrelated to the factor will be considered to be a trade or service receivable acquired from a related person and subject to the rules of this section if it is acquired in accordance with an arrangement that involves two or more groups of related persons that are unrelated to each other and the effect of the arrangement is that one or more related persons in each group acquire (directly or indirectly) trade or service receivables of one or more unrelated persons who are also parties to the arrangement, in exchange for reciprocal purchases of the first group's receivables. The following example illustrates the application of this paragraph (c)(3)(iii).

Example. Controlled foreign corporations A, B, C, and D are wholly-owned subsidiaries of domestic corporations M, N, O, and P, respectively. M, N, O, and P are not related persons. According to a prearranged plan, A, B, C, and D each acquire trade or service receivables of M, N, O, and/or P, except that neither A, B, C nor D acquires receivables of its own parent corporation. Because the effect of this arrangement is that the unrelated groups acquire each other's trade or service receivables pursuant to the arrangement, income derived by A, B, C, and D from the receivables acquired from M, N, O, and P

is interest income described in paragraph (a)(1) of this section.

(iv) *Financing arrangements.* If a controlled foreign corporation (as defined in section 957(a)) participates (directly or indirectly) in a lending transaction that results in a loan to the purchaser of inventory property, services, or trade or service receivables of a related person (or a loan to a person who is related to the purchaser), and if the loan would not have been made or maintained on the same terms but for the corresponding purchase, then the controlled foreign corporation shall be considered to have indirectly acquired a trade or service receivable, and income derived by the controlled foreign corporation from such a loan shall be considered to be income described in paragraph (a)(1) of this section. For purposes of this paragraph (c)(3)(iv), it is immaterial that the sums lent are not, in fact, the sums used to finance the purchase of a related person's inventory property, services, or trade or service receivables. The amount of income derived by the controlled foreign corporation to be taken into account shall be the total amount of income derived from a lending transaction described in this paragraph (c)(3)(iv), if the amount lent is less than or equal to the purchase price of the inventory property, services, or trade or service receivables. If the amount lent is greater than the purchase price of the inventory property, services or receivables, the amount to be taken into account shall be the proportion of the interest charge (including original issue discount) that the purchase price bears to the total amount lent pursuant to the lending transaction. The following examples illustrate the application of this paragraph (c)(3)(iv).

Example 1. P, a domestic corporation, owns all of the outstanding stock of FS1, a controlled foreign corporation engaged in the financing business in Country X. P manufactures and sells toys, including sales to C, an unrelated corporation. Prior to P's sale of toys to C for $2,000, D, a wholly-owned Country X subsidiary of C, borrows $3,000 from FS1. The loan from FS1 to D would not have been made or maintained on the same terms but for C's purchase of toys from P. Two-thirds of the income derived by FS1 from the loan to D is interest income described in paragraph (a)(1) of this section.

Example 2. P, a domestic corporation, owns all of the outstanding stock of FS1, a controlled foreign corporation organized under the laws of Country X. FS1 has accumulated cash reserves. P has uncollected trade and service receivables of foreign obligors. FS1 makes a $1,000 loan to U, a foreign corporation that is unrelated to P or FS1. U purchases P's trade and service receivables for $2,000. The loan would not have been made or maintained on the same terms but for U's purchase of P's receivables. The income derived by U from the receivables is not interest income within the meaning of paragraph (a) of this section. However, the interest paid by U to FS1 is interest income described in paragraph (a)(1) of this section.

Example 3. The facts are the same as in Example (2), except that U is a wholly-owned Country Y subsidiary of FS1. Because U is related to P within the meaning of paragraph (b)(2) of this section, under paragraph (c)(1) of this section, income derived by U from P's receivables is interest income described in paragraph (a)(1) of this section. In addition, the income derived by FS1 from the loan to U is interest income described in paragraph (a)(1) of this section.

(d) *Same country exception*—(1) *Income from trade or service receivables.* Income derived from a trade or service receivable acquired from a related person shall not be treated as interest income described in paragraph (a)(1) of this section if:

(i) The person acquiring the trade or service receivable and the related person are created or organized under the laws of the same foreign country;

(ii) The related person has a substantial part of its assets used in its trade or business located in such foreign country; and

(iii) The related person would not have derived foreign base company income, as defined in section 954(a) and the regulations thereunder, or income effectively connected with a United States trade or business from such receivable if the related person had collected the receivable.

For purposes of paragraph (d)(1)(ii) of this section, the standards contained in §1.954–2(e) shall apply in determining the location of a substantial part of the assets of a related person. For purposes of paragraph (d)(1)(iii) of this section, a determination of whether the related person would have derived foreign base company income shall be made without regard to the de minimis test described

in section 954(b)(3)(A). The following examples illustrate the application of this paragraph (d)(1).

Example 1. FS1, a controlled foreign corporation incorporated under the laws of Country X, owns all of the outstanding stock of FS2, which is also incorporated under the laws of Country X. FS1 has a substantial part of its assets used in its business in Country X. FS1 manufactures and sells toys for use in Country Y. The toys sold are considered to be manufactured in Country X under §1.954–3(a)(2). FS1 is not considered to have a branch or similar establishment in Country Y that is treated as a separate corporation under section 954(d)(2) and §1.954–3(b). Thus, gross income derived by FS1 from the toy sales is not foreign base company sales income. FS1 takes back receivables without stated interest from its customers. FS1 assigns those receivables to FS2. The income derived by FS2 from the receivables of FS1 is not interest income described in paragraph (a)(1) of this section, because it satisfies the same country exception under paragraph (d)(1) of this section.

Example 2. The facts are the same as in Example 1, except that the toys sold by FS1 are purchased from FS1's U.S. parent and are sold for use outside of Country X. Thus, any income derived by FS1 from the sale of the toys would be foreign base company sales income. Therefore, income derived by FS2 from the receivables of FS1 is interest income described in paragraph (a)(1) of this section. FS2 is considered to derive interest income from the receivable even if, solely by reason of the de minimis rule of section 954(b)(3)(A), FS1 would not have derived foreign base company income if FS1 had collected the receivable.

(2) *Income from financing arrangements.* Income derived by a controlled foreign corporation from a loan to a person that purchases inventory property or services of a person that is related to the controlled foreign corporation, or from other loans described in paragraph (c)(3)(iv) of this section, shall not be treated as interest income described in paragraph (a)(1) of this section if:

(i) The person providing the financing and the related person are created or organized under the laws of the same foreign country;

(ii) The related person has a substantial part of its assets used in its trade or business located in such foreign country; and

(iii) The related person would not have derived foreign base company income or income effectively connected with a United States trade or business:

(A) From the sale of inventory property or services to the borrower or from financing the borrower's purchase of inventory property or services, in the case of a loan to the purchaser of inventory property or services of a related person; or

(B) From collecting amounts due under the receivable or from financing the purchase of the receivable, in the case of a loan to the purchaser of a trade or service receivable of a related person.

For purposes of paragraph (d)(2)(ii) of this section, the standards contained in §1.954–2(e) shall apply in determining the location of a substantial part of the assets of a related person. For purposes of paragraph (d)(2)(iii) of this section, a determination of whether the related person would have derived foreign base company income shall be made without regard to the de minimis test described in section 954(b)(3)(A). The following examples illustrate the application of this paragraph (d)(2).

Example 1. FS1, a controlled foreign corporation incorporated under the laws of Country X, owns all of the outstanding stock of FS2, which is also incorporated under the laws of Country X. FS1, which has a substantial part of its assets used in its business located in Country X, manufactures and sells toys for use in Country Y. The toys sold are considered to be manufactured in Country X under §1.954–3(a)(2). FS1 is not considered to have a branch or similar establishment in Country Y that is treated as a separate corporation under section 954(d)(2) and §1.954–3(b). Thus, the gross income derived by FS1 from the toy sales is not foreign base company sales income. FS2 makes a loan to FS3, a wholly-owned subsidiary of FS1 which is also incorporated under the laws of Country X, in connection with FS3's purchase of toys from FS1. FS3 does not earn any subpart F gross income. Thus, FS1 would not have derived foreign personal holding company interest income if FS1 had made the loan to FS3, because the interest would be covered by the same country exception of section 954(c)(3). Therefore, the income derived by FS2 from its loan to FS3 is not treated as interest income described in paragraph (a)(1) of this section, because it satisfies the same country exception under paragraph (d)(2) of this section. Such income is also not treated as foreign personal holding company income described in section 954(c)(1)(A) because the same country exception of section 954(c)(3)

also applies to the interest actually derived by FS2 from its loan to FS3.

Example 2. FS1, a controlled foreign corporation incorporated under the laws of Country X, owns all of the outstanding stock of FS2, which is also incorporated under the laws of Country X. FS1 purchases toys from its U.S. parent and resells them for use outside of Country X. As part of a sales transaction, FS1 takes back trade receivables. FS2 makes a loan to U, an unrelated corporation, to finance U's purchase of FS1's trade receivables. Because FS1 would have derived foreign base company income if FS1 had collected the receivables or made the loan itself, the same country exception of paragraph (d)(2) of this section does not apply. Accordingly, under paragraph (c)(3)(iv) of this section, the income derived by FS2 from its loan to U is treated as interest income described in paragraph (a)(1) of this section.

(e) *Special rules*—(1) *Foreign personal holding companies and controlled foreign corporations.* For purposes of sections 551–558 (relating to foreign personal holding companies), the exclusion provided by section 552(c) for interest described in section 954(c)(3)(A) shall not apply to income described in paragraph (a)(1) of this section. For purposes of the sections 951–964 (relating to controlled foreign corporations), income described in paragraph (a)(1) of this section shall be included in a United States shareholder's pro rata share of a controlled foreign corporation's subpart F income without regard to the de minimis rule under section 954(b)(3)(A). However, income described in paragraph (a)(1) of this section shall be included in the computation of a controlled foreign corporation's foreign base company income for purposes of applying the de minimis rule under section 954(b)(3)(A) and the more than 70 percent of gross income test under section 954(b)(3)(B). In addition, income described in paragraph (a)(1) of this section shall be considered to be subpart F income without regard to the exclusions from foreign base company income provided by section 954(c)(2)(B) (relating to export financing interest derived in the conduct of a banking business) and section 954(c)(3)(A)(i) (relating to certain interest income received from related persons).

(2) *Foreign tax credit.* Income described in paragraph (a)(1) of this section shall be considered to be interest income for purposes of the section 904 foreign tax credit limitation and is not eligible for the exceptions for export financing interest provided in section 904(d)(2) (A)(iii)(II), (B)(ii), and (C)(iii). In addition, such income will be subject to the look-through rule for subpart F income set forth in section 904(d)(3) without regard to the de minimis exception provided in section 904(d)(3)(E).

(3) *Possessions corporations*—(i) *Limitation on credit.* Income described in paragraph (a)(1) of this section shall not be treated as income described in section 936(a)(1) (A) or (B) unless the income is considered under the principles of §1.863–6 to be derived from sources within the possessions. Thus, the credit provided by section 936 is not available for income described in paragraph (a)(1) of this section unless the obligor under the receivable is a resident of a possession. In the case of a loan described in section 864(d)(6), the credit provided by section 936 is not available for income described in paragraph (a)(1) of this section unless the purchaser of the inventory property or services is a resident of a possession.

(ii) *Eligibility determination.* Notwithstanding the limitation on the availability of the section 936 credit for income described in paragraph (a)(1) of this section, if income treated as interest income under paragraph (a)(1) of this section is derived from sources within a possession (determined without regard to this section), such income shall be eligible for inclusion in a corporation's gross income for purposes of section 936(a)(2)(A). If such income is derived from the active conduct of a trade or business within a possession (determined without regard to this section), such income shall be eligible for inclusion in a corporation's gross income for purposes of section 936(a)(2)(B). (These rules apply for purposes of determining whether a corporation is eligible to elect the credit provided under section 936(a).)

(iii) *Example.* The following example illustrates the application of paragraph (e)(3) of this section.

Example. Corporation X is operating in a possession as a possessions corporation. In

1985, X earned $50,000 from the active conduct of a business in the possession, including $5,000 from trade or service receivables acquired from a related party. Obligors under the receivables acquired by X are not residents of the possession. Corporation X also earned $20,000 from activities other than its active conduct of business in the possession. The $5,000 derived by X from the receivables is not eligible for the section 936 credit. However, the $5,000 may be used by X to meet the percentage tests under section 936(a)(2) to the extent that such income is considered to be derived from sources within the possession (for purposes of section 936(a)(2)(A)) or is considered to be derived from the active conduct of a trade or business in the possession (for purposes of section 936(a)(2)(B)), in either case determined without regard to the characterization of such income under this section.

(f) *Effective date.* The provisions of this section shall apply with respect to accounts receivable and evidences of indebtedness transferred after March 1, 1984 and are effective June 14, 1988.

[T.D. 8209, 53 FR 22166, June 14, 1988]

§ 1.865–1 Loss with respect to personal property other than stock.

(a) *General rules for allocation of loss*—(1) *Allocation against gain.* Except as otherwise provided in § 1.865–2 and paragraph (c) of this section, loss recognized with respect to personal property shall be allocated to the class of gross income and, if necessary, apportioned between the statutory grouping of gross income (or among the statutory groupings) and the residual grouping of gross income, with respect to which gain from a sale of such property would give rise in the hands of the seller. For purposes of this section, loss includes bad debt deductions under section 166 and loss on property that is marked-to-market (such as under section 475) and subject to the rules of this section. Thus, for example, loss recognized by a United States resident on the sale or worthlessness of a bond generally is allocated to reduce United States source income.

(2) *Loss attributable to foreign office.* Except as otherwise provided in § 1.865–2 and paragraph (c) of this section, and except with respect to loss subject to paragraph (b) of this section, in the case of loss recognized by a United States resident with respect to property that is attributable to an office or other fixed place of business in a foreign country within the meaning of section 865(e)(3), the loss shall be allocated to reduce foreign source income if a gain on the sale of the property would have been taxable by the foreign country and the highest marginal rate of tax imposed on such gains in the foreign country is at least 10 percent. However, paragraph (a)(1) of this section and not this paragraph (a)(2) will apply if gain on the sale of such property would be sourced under section 865(c), (d)(1)(B), or (d)(3).

(3) *Loss recognized by United States citizen or resident alien with foreign tax home.* Except as otherwise provided in § 1.865–2 and paragraph (c) of this section, and except with respect to loss subject to paragraph (b) of this section, in the case of loss with respect to property recognized by a United States citizen or resident alien that has a tax home (as defined in section 911(d)(3)) in a foreign country, the loss shall be allocated to reduce foreign source income if a gain on the sale of such property would have been taxable by a foreign country and the highest marginal rate of tax imposed on such gains in the foreign country is at least 10 percent.

(4) *Allocation for purposes of section 904.* For purposes of section 904, loss recognized with respect to property that is allocated to foreign source income under this paragraph (a) shall be allocated to the separate category under section 904(d) to which gain on the sale of the property would have been assigned (without regard to section 904(d)(2)(A)(iii)(III)). For purposes of § 1.904–4(c)(2)(ii)(A), any such loss allocated to passive income shall be allocated (prior to the application of § 1.904–4(c)(2)(ii)(B)) to the group of passive income to which gain on a sale of the property would have been assigned had a sale of the property resulted in the recognition of a gain under the law of the relevant foreign jurisdiction or jurisdictions.

(5) *Loss recognized by partnership.* A partner's distributive share of loss recognized by a partnership with respect to personal property shall be allocated and apportioned in accordance with this section as if the partner had recognized the loss. If loss is attributable to

an office or other fixed place of business of the partnership within the meaning of section 865(e)(3), such office or fixed place of business shall be considered to be an office of the partner for purposes of this section.

(b) *Special rules of application*—(1) *Depreciable property*. In the case of a loss recognized with respect to depreciable personal property, the gain referred to in paragraph (a)(1) of this section is the gain that would be sourced under section 865(c)(1) (depreciation recapture).

(2) *Contingent payment debt instrument*. Loss described in the last sentence of §1.1275–4(b)(9)(iv)(A) that is recognized with respect to a contingent payment debt instrument to which §1.1275–4(b) applies (instruments issued for money or publicly traded property) shall be allocated to the class of gross income and, if necessary, apportioned between the statutory grouping of gross income (or among the statutory groupings) and the residual grouping of gross income, with respect to which interest income from the instrument (in the amount of the loss subject to this paragraph (b)(2)) would give rise.

(c) *Exceptions*—(1) *Foreign currency and certain financial instruments*. This section does not apply to loss governed by section 988 and loss recognized with respect to options contracts or derivative financial instruments, including futures contracts, forward contracts, notional principal contracts, or evidence of an interest in any of the foregoing.

(2) *Inventory*. This section does not apply to loss recognized with respect to property described in section 1221(a)(1).

(3) *Interest equivalents and trade receivables*. Loss subject to §1.861–9T(b) (loss equivalent to interest expense and loss on trade receivables) shall be allocated and apportioned under the rules of §1.861–9T and not under the rules of this section.

(4) *Unamortized bond premium*. If a taxpayer recognizing loss with respect to a bond (within the meaning of §1.171–1(b)) did not amortize bond premium to the full extent permitted by section 171 and the regulations thereunder, then, to the extent of the amount of bond premium that could have been, but was not, amortized by the taxpayer, loss recognized with respect to the bond shall be allocated to the class of gross income and, if necessary, apportioned between the statutory grouping of gross income (or among the statutory groupings) and the residual grouping of gross income, with respect to which interest income from the bond was assigned.

(5) *Accrued interest*. Loss attributable to accrued but unpaid interest on a debt obligation shall be allocated to the class of gross income and, if necessary, apportioned between the statutory grouping of gross income (or among the statutory groupings) and the residual grouping of gross income, with respect to which interest income from the obligation was assigned. For purposes of this section, whether loss is attributable to accrued but unpaid interest (rather than to principal) shall be determined under the principles of §§1.61–7(d) and 1.446–2(e).

(6) *Anti-abuse rules*—(i) *Transactions involving built-in losses*. If one of the principal purposes of a transaction is to change the allocation of a built-in loss with respect to personal property by transferring the property to another person, qualified business unit, office or other fixed place of business, or branch that subsequently recognizes the loss, the loss shall be allocated by the transferee as if it were recognized by the transferor immediately prior to the transaction. If one of the principal purposes of a change of residence is to change the allocation of a built-in loss with respect to personal property, the loss shall be allocated as if the change of residence had not occurred. If one of the principal purposes of a transaction is to change the allocation of a built-in loss on the disposition of personal property by converting the original property into other property and subsequently recognizing loss with respect to such other property, the loss shall be allocated as if it were recognized with respect to the original property immediately prior to the transaction. Transactions subject to this paragraph shall include, without limitation, reorganizations within the meaning of section 368(a), liquidations under section 332, transfers to a corporation under section 351, transfers to a partnership under section 721, transfers to a trust,

distributions by a partnership, distributions by a trust, transfers to or from a qualified business unit, office or other fixed place of business, or branch, or exchanges under section 1031. A person may have a principal purpose of affecting loss allocation even though this purpose is outweighed by other purposes (taken together or separately).

(ii) *Offsetting positions*. If a taxpayer recognizes loss with respect to personal property and the taxpayer (or any person described in section 267(b) (after application of section 267(c)), 267(e), 318 or 482 with respect to the taxpayer) holds (or held) offsetting positions with respect to such property with a principal purpose of recognizing foreign source income and United States source loss, the loss shall be allocated and apportioned against such foreign source income. For purposes of this paragraph (c)(6)(ii), positions are offsetting if the risk of loss of holding one or more positions is substantially diminished by holding one or more other positions.

(iii) *Matching rule*. If a taxpayer (or a person described in section 1059(c)(3)(C) with respect to the taxpayer) engages in a transaction or series of transactions with a principal purpose of recognizing foreign source income that results in the creation of a corresponding loss with respect to personal property (as a consequence of the rules regarding the timing of recognition of income, for example), the loss shall be allocated and apportioned against such income to the extent of the recognized foreign source income. For an example illustrating a similar rule with respect to stock loss, see § 1.865–2(b)(4)(iv) *Example 3*.

(d) *Definitions*—(1) *Contingent payment debt instrument*. A contingent payment debt instrument is any debt instrument that is subject to § 1.1275–4.

(2) *Depreciable personal property*. Depreciable personal property is any property described in section 865(c)(4)(A).

(3) *Terms defined in § 1.861–8*. See § 1.861–8 for the meaning of *class of gross income*, *statutory grouping of gross income*, and *residual grouping of gross income*.

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

Example 1. On January 1, 2000, *A*, a domestic corporation, purchases for $1,000 a machine that produces widgets, which *A* sells in the United States and throughout the world. Throughout *A*'s holding period, the machine is located and used in Country *X*. During *A*'s holding period, *A* incurs depreciation deductions of $400 with respect to the machine. Under § 1.861–8, *A* allocates and apportions depreciation deductions of $250 against foreign source general limitation income and $150 against U.S. source income. On December 12, 2002, A sells the machine for $100 and recognizes a loss of $500. Because the machine was used predominantly outside the United States, under sections 865(c)(1)(B) and 865(c)(3)(B)(ii) gain on the disposition of the machine would be foreign source general limitation income to the extent of the depreciation adjustments. Therefore, under paragraph (b)(1) of this section, the entire $500 loss is allocated against foreign source general limitation income.

Example 2. On January 1, 2002, *A*, a domestic corporation, loans $2,000 to *N*, its wholly-owned controlled foreign corporation, in exchange for a contingent payment debt instrument subject to § 1.1275–4(b). During 2002 through 2004, *A* accrues and receives interest income of $630, $150 of which is foreign source general limitation income and $480 of which is foreign source passive income under section 904(d)(3). Assume there are no positive or negative adjustments pursuant to § 1.1275–4(b)(6) in 2002 through 2004. On January 1, 2005, *A* disposes of the debt instrument and recognizes a $770 loss. Under § 1.1275–4(b)(8)(ii), $630 of the loss is treated as ordinary loss and $140 is treated as capital loss. Assume that $140 of interest income earned in 2005 with respect to the debt instrument would be foreign source passive income under section 904(d)(3). Under § 1.1275–4(b)(9)(iv), $150 of the ordinary loss is allocated against foreign source general limitation income and $480 of the ordinary loss is allocated against foreign source passive income. Under paragraph (b)(2) of this section, the $140 capital loss is allocated against foreign source passive income.

Example 3. (i) On January 1, 2003, *A*, a domestic corporation, purchases for $1,200 a taxable bond maturing on December 31, 2008, with a stated principal amount of $1,000, payable at maturity. The bond provides for unconditional payments of interest of $100, payable December 31 of each year. The issuer of the bond is a foreign corporation and interest on the bond is thus foreign source. Interest payments for 2003 and 2004 are timely made. *A* does not elect to amortize its bond

premium under section 171 and the regulations thereunder, which would have permitted *A* to offset the $100 of interest income by $28.72 of bond premium in 2003, and by $30.42 in 2004. On January 1, 2005, *A* sells the bond and recognizes a $100 loss. Under paragraph (c)(4) of this section, $59.14 of the loss is allocated against foreign source income. Under paragraph (a)(1) of this section, the remaining $40.86 of the loss is allocated against U.S. source income.

(ii) The facts are the same as in paragraph (i) of this *Example 3*, except that *A* made the election to amortize its bond premium effective for taxable year 2004 (see §1.171–4(c)). Under paragraph (c)(4) of this section, $28.72 of the loss is allocated against foreign source income. Under paragraph (a)(1) of this section, the remaining $71.28 of the loss is allocated against U.S. source income.

Example 4. On January 1, 2002, *A*, a domestic corporation, purchases for $1,000 a bond maturing December 31, 2014, with a stated principal amount of $1,000, payable at maturity. The bond provides for unconditional payments of interest of $100, payable December 31 of each year. The issuer of the bond is a foreign corporation and interest on the bond is thus foreign source. Between 2002 and 2006, *A* accrues and receives foreign source interest income of $500 with respect to the bond. On January 1, 2007, *A* sells the bond and recognizes a $500 loss. Under paragraph (a)(1) of this section, the $500 loss is allocated against U.S. source income.

Example 5. On January 1, 2002, *A*, a domestic corporation on the accrual method of accounting, purchases for $1,000 a bond maturing December 31, 2012, with a stated principal amount of $1,000, payable at maturity. The bond provides for unconditional payments of interest of $100, payable December 31 of each year. The issuer of the bond is a foreign corporation and interest on the bond is thus foreign source. On June 10, 2002, after *A* has accrued $44 of interest income, but before any interest has been paid, the issuer suddenly becomes insolvent and declares bankruptcy. *A* sells the bond (including the accrued interest) for $20. Assuming that *A* properly accrued $44 of interest income, *A* treats the $20 proceeds from the sale of the bond as payment of interest previously accrued and recognizes a $1,000 loss with respect to the bond principal and a $24 loss with respect to the accrued interest. See §1.61–7(d). Under paragraph (a)(1) of this section, the $1,000 loss with respect to the principal is allocated against U.S. source income. Under paragraph (c)(5) of this section, the $24 loss with respect to accrued but unpaid interest is allocated against foreign source interest income.

(f) *Effective date*—(1) *In general*. Except as provided in paragraph (f)(2) of this section, this section is applicable to loss recognized on or after January 8, 2002. For purposes of this paragraph (f), loss that is recognized but deferred (for example, under section 267 or 1092) shall be treated as recognized at the time the loss is taken into account.

(2) *Application to prior periods*. A taxpayer may apply the rules of this section to losses recognized in any taxable year beginning on or after January 1, 1987, and all subsequent years, provided that—

(i) The taxpayer's tax liability as shown on an original or amended tax return is consistent with the rules of this section for each such year for which the statute of limitations does not preclude the filing of an amended return on June 30, 2002; and

(ii) The taxpayer makes appropriate adjustments to eliminate any double benefit arising from the application of this section to years that are not open for assessment.

(3) *Examples*. See §1.865–2(e)(3) for examples illustrating an applicability date provision similar to the applicability date provided in this paragraph (f).

[T.D. 8973, 66 FR 67083, Dec. 28, 2001]

§1.865–2 Loss with respect to stock.

(a) *General rules for allocation of loss with respect to stock*—(1) *Allocation against gain*. Except as otherwise provided in paragraph (b) of this section, loss recognized with respect to stock shall be allocated to the class of gross income and, if necessary, apportioned between the statutory grouping of gross income (or among the statutory groupings) and the residual grouping of gross income, with respect to which gain (other than gain treated as a dividend under section 964(e)(1) or 1248) from a sale of such stock would give rise in the hands of the seller (without regard to section 865(f)). For purposes of this section, loss includes loss on property that is marked-to-market (such as under section 475) and subject to the rules of this section. Thus, for example, loss recognized by a United States resident on the sale of stock generally is allocated to reduce United States source income.

(2) *Stock attributable to foreign office*. Except as otherwise provided in paragraph (b) of this section, in the case of

loss recognized by a United States resident with respect to stock that is attributable to an office or other fixed place of business in a foreign country within the meaning of section 865(e)(3), the loss shall be allocated to reduce foreign source income if a gain on the sale of the stock would have been taxable by the foreign country and the highest marginal rate of tax imposed on such gains in the foreign country is at least 10 percent.

(3) *Loss recognized by United States citizen or resident alien with foreign tax home*—(i) *In general.* Except as otherwise provided in paragraph (b) of this section, in the case of loss with respect to stock that is recognized by a United States citizen or resident alien that has a tax home (as defined in section 911(d)(3)) in a foreign country, the loss shall be allocated to reduce foreign source income if a gain on the sale of the stock would have been taxable by a foreign country and the highest marginal rate of tax imposed on such gains in the foreign country is at least 10 percent.

(ii) *Bona fide residents of Puerto Rico.* Except as otherwise provided in paragraph (b) of this section, in the case of loss with respect to stock in a corporation described in section 865(g)(3) recognized by a United States citizen or resident alien that is a bona fide resident of Puerto Rico during the entire taxable year, the loss shall be allocated to reduce foreign source income. If gain from a sale of such stock would give rise to income exempt from tax under section 933, the loss with respect to such stock shall be allocated to amounts that are excluded from gross income under section 933(1) and therefore shall not be allowed as a deduction from gross income. See section 933(1) and § 1.933–1(c).

(4) *Stock constituting a United States real property interest.* Loss recognized by a nonresident alien individual or a foreign corporation with respect to stock that constitutes a United States real property interest shall be allocated to reduce United States source income. For additional rules governing the treatment of such loss, see section 897 and the regulations thereunder.

(5) *Allocation for purposes of section 904.* For purposes of section 904, loss recognized with respect to stock that is allocated to foreign source income under this paragraph (a) shall be allocated to the separate category under section 904(d) to which gain on a sale of the stock would have been assigned (without regard to section 904(d)(2)(A)(iii)(III)). For purposes of § 1.904–4(c)(2)(ii)(A), any such loss allocated to passive income shall be allocated (prior to the application of § 1.904–4(c)(2)(ii)(B)) to the group of passive income to which gain on a sale of the stock would have been assigned had a sale of the stock resulted in the recognition of a gain under the law of the relevant foreign jurisdiction or jurisdictions.

(b) *Exceptions*—(1) *Dividend recapture exception*—(i) *In general.* If a taxpayer recognizes a loss with respect to shares of stock, and the taxpayer (or a person described in section 1059(c)(3)(C) with respect to such shares) included in income a dividend recapture amount (or amounts) with respect to such shares at any time during the recapture period, then, to the extent of the dividend recapture amount (or amounts), the loss shall be allocated and apportioned on a proportionate basis to the class or classes of gross income or the statutory or residual grouping or groupings of gross income to which the dividend recapture amount was assigned.

(ii) *Exception for de minimis amounts.* Paragraph (b)(1)(i) of this section shall not apply to a loss recognized by a taxpayer on the disposition of stock if the sum of all dividend recapture amounts (other than dividend recapture amounts eligible for the exception described in paragraph (b)(1)(iii) of this section (passive limitation dividends)) included in income by the taxpayer (or a person described in section 1059(c)(3)(C)) with respect to such stock during the recapture period is less than 10 percent of the recognized loss.

(iii) *Exception for passive limitation dividends.* Paragraph (b)(1)(i) of this section shall not apply to the extent of a dividend recapture amount that is treated as income in the separate category for passive income described in section 904(d)(2)(A) (without regard to section 904(d)(2)(A)(iii)(III)). The exception provided for in this paragraph

(b)(1)(iii) shall not apply to any dividend recapture amount that is treated as income in the separate category for financial services income described in section 904(d)(2)(C).

(iv) *Examples*. The application of this paragraph (b)(1) may be illustrated by the following examples:

Example 1. (i) *P*, a domestic corporation, is a United States shareholder of *N*, a controlled foreign corporation. *N* has never had any subpart F income and all of its earnings and profits are described in section 959(c)(3). On May 5, 1998, *N* distributes a dividend to *P* in the amount of $100. The dividend gives rise to a $5 foreign withholding tax, and *P* is deemed to have paid an additional $45 of foreign income tax with respect to the dividend under section 902. Under the look-through rules of section 904(d)(3) the dividend is general limitation income described in section 904(d)(1)(I).

(ii) On February 6, 2000, *P* sells its shares of *N* and recognizes a $110 loss. In 2000, *P* has the following taxable income, excluding the loss on the sale of *N*:

(A) $1,000 of foreign source income that is general limitation income described in section 904(d)(1)(I);

(B) $1,000 of foreign source capital gain from the sale of stock in a foreign affiliate that is sourced under section 865(f) and is passive income described in section 904(d)(1)(A); and

(C) $1,000 of U.S. source income.

(iii) The $100 dividend paid in 1998 is a dividend recapture amount that was included in *P*'s income within the recapture period preceding the disposition of the *N* stock. The *de minimis* exception of paragraph (b)(1)(ii) of this section does not apply because the $100 dividend recapture amount exceeds 10 percent of the $110 loss. Therefore, to the extent of the $100 dividend recapture amount, the loss must be allocated under paragraph (b)(1)(i) of this section to the separate limitation category to which the dividend was assigned (general limitation income).

(iv) *P*'s remaining $10 loss on the disposition of the *N* stock is allocated to U.S. source income under paragraph (a)(1) of this section.

(v) After allocation of the stock loss, *P*'s foreign source taxable income in 2000 consists of $900 of foreign source general limitation income and $1,000 of foreign source passive income.

Example 2. (i) *P*, a domestic corporation, owns all of the stock of *N1*, which owns all of the stock of *N2*, which owns all of the stock of *N3*. *N1*, *N2*, and *N3* are controlled foreign corporations. All of the corporations use the calendar year as their taxable year. On February 5, 1997, *N3* distributes a dividend to *N2*. The dividend is foreign personal holding company income of *N2* under section 954(c)(1)(A) that results in an inclusion of $100 in *P*'s income under section 951(a)(1)(A)(i) as of December 31, 1997. Under section 904(d)(3)(B) the inclusion is general limitation income described in section 904(d)(1)(I). The income inclusion to *P* results in a corresponding increase in *P*'s basis in the stock of *N1* under section 961(a).

(ii) On March 5, 1999, *P* sells its shares of *N1* and recognizes a $110 loss. The $100 1997 subpart F inclusion is a dividend recapture amount that was included in *P*'s income within the recapture period preceding the disposition of the *N1* stock. The de minimis exception of paragraph (b)(1)(ii) of this section does not apply because the $100 dividend recapture amount exceeds 10 percent of the $110 loss. Therefore, to the extent of the $100 dividend recapture amount, the loss must be allocated under paragraph (b)(1)(i) of this section to the separate limitation category to which the dividend recapture amount was assigned (general limitation income). The remaining $10 loss is allocated to U.S. source income under paragraph (a)(1) of this section.

Example 3. (i) *P*, a domestic corporation, owns all of the stock of *N1*, which owns all of the stock of *N2*. *N1* and *N2* are controlled foreign corporations. All the corporations use the calendar year as their taxable year and the U.S. dollar as their functional currency. On May 5, 1998, *N2* pays a dividend of $100 to *N1* out of general limitation earnings and profits.

(ii) On February 5, 2000, *N1* sells its *N2* stock to an unrelated purchaser. The sale results in a loss to *N1* of $110 for U.S. tax purposes. In 2000, *N1* has the following current earnings and profits, excluding the loss on the sale of *N2*:

(A) $1,000 of non-subpart F foreign source general limitation earnings and profits described in section 904(d)(1)(I);

(B) $1,000 of foreign source gain from the sale of stock that is taken into account in determining foreign personal holding company income under section 954(c)(1)(B)(i) and which is passive limitation earnings and profits described in section 904(d)(1)(A);

(C) $1,000 of foreign source interest income received from an unrelated person that is foreign personal holding company income under section 954(c)(1)(A) and which is passive limitation earnings and profits described in section 904(d)(1)(A).

(iii) The $100 dividend paid in 1998 is a dividend recapture amount that was included in *N1*'s income within the recapture period preceding the disposition of the *N2* stock. The *de minimis* exception of paragraph (b)(1)(ii) of this section does not apply because the $100 dividend recapture amount exceeds 10 percent of the $110 loss. Therefore, to the extent of the $100 dividend recapture amount, the loss must be allocated under paragraph

(b)(1)(i) of this section to the separate limitation category to which the dividend was assigned (general limitation earnings and profits).

(iv) *N1*'s remaining $10 loss on the disposition of the *N2* stock is allocated to foreign source passive limitation earnings and profits under paragraph (a)(1) of this section.

(v) After allocation of the stock loss, *N1*'s current earnings and profits for 1998 consist of $900 of foreign source general limitation earnings and profits and $1,990 of foreign source passive limitation earnings and profits.

(vi) After allocation of the stock loss, *N1*'s subpart F income for 2000 consists of $1,000 of foreign source interest income that is foreign personal holding company income under section 954(c)(1)(A) and $890 of foreign source net gain that is foreign personal holding company income under section 954(c)(1)(B)(i). *P* includes $1,890 in income under section 951(a)(1)(A)(i) as passive income under sections 904(d)(1)(A) and 904(d)(3)(B).

Example 4. P, a foreign corporation, has two wholly-owned subsidiaries, *S*, a domestic corporation, and *B*, a foreign corporation. On January 1, 2000, *S* purchases a one-percent interest in *N*, a foreign corporation, for $100. On January 2, 2000, *N* distributes a $20 dividend to *S*. The $20 dividend is foreign source financial services income. On January 3, 2000, *S* sells its *N* stock to *B* for $80 and recognizes a $20 loss that is deferred under section 267(f). On June 10, 2008, *B* sells its *N* stock to an unrelated person for $55. Under section 267(f) and § 1.267(f)–1(c)(1), *S*'s $20 loss is deferred until 2008. Under this paragraph (b)(1), the $20 loss is allocated to reduce foreign source financial services income in 2008 because the loss was recognized (albeit deferred) within the 24-month recapture period following the receipt of the dividend. See §§ 1.267(f)–1(a)(2)(i)(B) and 1.267(f)–1(c)(2).

Example 5. The facts are the same as in *Example 4*, except *P*, *S*, and *B* are domestic corporations and members of the *P* consolidated group. Under the matching rule of § 1.1502–13(c)(1), the separate entity attributes of *S*'s intercompany items and *B*'s corresponding items are redetermined to the extent necessary to produce the same effect on consolidated taxable income as if *S* and *B* were divisions of a single corporation and the intercompany transaction was a transaction between divisions. If *S* and *B* were divisions of a single corporation, the transfer of *N* stock on January 3, 2000 would be ignored for tax purposes, and the corporation would be treated as selling that stock only in 2008. Thus, the corporation's entire $45 loss would have been allocated against U.S. source income under paragraph (a)(1) of this section because a dividend recapture amount was not received during the corporation's recapture period. Accordingly, *S*'s $20 loss and *B*'s $25 loss are allocated to reduce U.S. source income.

Example 6. (i) On January 1, 1998, *P*, a domestic corporation, purchases *N*, a foreign corporation, for $1,000. On March 1, 1998, *P* causes *N* to sell its operating assets, distribute a $400 general limitation dividend to *P*, and invest its remaining $600 in short-term government securities. *P* converted the *N* assets into low-risk investments with a principal purpose of holding the *N* stock without significant risk of loss until the recapture period expired. *N* earns interest income from the securities. The income constitutes subpart F income that is included in *P*'s income under section 951, increasing *P*'s basis in the *N* stock under section 961(a). On March 1, 2002, *P* sells *N* and recognizes a $400 loss.

(ii) Pursuant to paragraph (d)(3) of this section, the recapture period is increased by the period in which *N*'s assets were held as low-risk investments because *P* caused *N*'s assets to be converted into and held as low-risk investments with a principal purpose of enabling *P* to hold the *N* stock without significant risk of loss. Accordingly, under paragraph (b)(1)(i) of this section the $400 loss is allocated against foreign source general limitation income.

(2) *Exception for inventory*. This section does not apply to loss recognized with respect to stock described in section 1221(1).

(3) *Exception for stock in an S corporation*. This section does not apply to loss recognized with respect to stock in an S corporation (as defined in section 1361).

(4) *Anti-abuse rules*—(i) *Transactions involving built-in losses*. If one of the principal purposes of a transaction is to change the allocation of a built-in loss with respect to stock by transferring the stock to another person, qualified business unit (within the meaning of section 989(a)), office or other fixed place of business, or branch that subsequently recognizes the loss, the loss shall be allocated by the transferee as if it were recognized with respect to the stock by the transferor immediately prior to the transaction. If one of the principal purposes of a change of residence is to change the allocation of a built-in loss with respect to stock, the loss shall be allocated as if the change of residence had not occurred. If one of the principal purposes of a transaction is to change the allocation of a built-in loss with respect to stock

(or other personal property) by converting the original property into other property and subsequently recognizing loss with respect to such other property, the loss shall be allocated as if it were recognized with respect to the original property immediately prior to the transaction. Transactions subject to this paragraph shall include, without limitation, reorganizations within the meaning of section 368(a), liquidations under section 332, transfers to a corporation under section 351, transfers to a partnership under section 721, transfers to a trust, distributions by a partnership, distributions by a trust, or transfers to or from a qualified business unit, office or other fixed place of business. A person may have a principal purpose of affecting loss allocation even though this purpose is outweighed by other purposes (taken together or separately).

(ii) *Offsetting positions.* If a taxpayer recognizes loss with respect to stock and the taxpayer (or any person described in section 267(b) (after application of section 267(c)), 267(e), 318 or 482 with respect to the taxpayer) holds (or held) offsetting positions with respect to such stock with a principal purpose of recognizing foreign source income and United States source loss, the loss will be allocated and apportioned against such foreign source income. For purposes of this paragraph (b)(4)(ii), positions are offsetting if the risk of loss of holding one or more positions is substantially diminished by holding one or more other positions.

(iii) *Matching rule.* If a taxpayer (or a person described in section 1059(c)(3)(C) with respect to the taxpayer) engages in a transaction or series of transactions with a principal purpose of recognizing foreign source income that results in the creation of a corresponding loss with respect to stock (as a consequence of the rules regarding the timing of recognition of income, for example), the loss shall be allocated and apportioned against such income to the extent of the recognized foreign source income. This paragraph (b)(4)(iii) applies to any portion of a loss that is not allocated under paragraph (b)(1)(i) of this section (dividend recapture rule), including a loss in excess of the dividend recapture amount and a loss that is related to a dividend recapture amount described in paragraph (b)(1)(ii) (de minimis exception) or (b)(1)(iii) (passive dividend exception) of this section.

(iv) *Examples.* The application of this paragraph (b)(4) may be illustrated by the following examples. No inference is intended regarding the application of any other Internal Revenue Code section or judicial doctrine that may apply to disallow or defer the recognition of loss. The examples are as follows:

Example 1. (i) *Facts.* On January 1, 2000, *P*, a domestic corporation, owns all of the stock of *N1*, a controlled foreign corporation, which owns all of the stock of *N2*, a controlled foreign corporation. *N1*'s basis in the stock of *N2* exceeds its fair market value, and any loss recognized by *N1* on the sale of *N2* would be allocated under paragraph (a)(1) of this section to reduce foreign source passive limitation earnings and profits of *N1*. In contemplation of the sale of *N2* to an unrelated purchaser, *P* causes *N1* to liquidate with principal purposes of recognizing the loss on the *N2* stock and allocating the loss against U.S. source income. *P* sells the *N2* stock and *P* recognizes a loss.

(ii) *Loss allocation.* Because one of the principal purposes of the liquidation was to transfer the stock to *P* in order to change the allocation of the built-in loss on the *N2* stock, under paragraph (b)(4)(i) of this section the loss is allocated against *P*'s foreign source passive limitation income.

Example 2. (i) *Facts.* On January 1, 2000, *P*, a domestic corporation, forms *N* and *F*, foreign corporations, and contributes $1,000 to the capital of each. *N* and *F* enter into offsetting positions in financial instruments that produce financial services income. Holding the *N* stock substantially diminishes *P*'s risk of loss with respect to the *F* stock (and vice versa). *P* holds *N* and *F* with a principal purpose of recognizing foreign source income and U.S. source loss. On March 31, 2000, when the financial instrument held by *N* is worth $1,200 and the financial instrument held by *F* is worth $800, *P* sells its *F* stock and recognizes a $200 loss.

(ii) *Loss allocation.* Because *P* held an offsetting position with respect to the *F* stock with a principal purpose of recognizing foreign source income and U.S. source loss, the $200 loss is allocated against foreign source financial services income under paragraph (b)(4)(ii) of this section.

Example 3. (i) *Facts.* On January 1, 2002, *P* and *Q*, domestic corporations, form *R*, a domestic partnership. The corporations and partnership use the calendar year as their

taxable year. *P* contributes $900 to *R* in exchange for a 90-percent partnership interest and *Q* contributes $100 to *R* in exchange for a 10-percent partnership interest. *R* purchases a dance studio in Country *X* for $1,000. On January 2, 2002, *R* enters into contracts to provide dance lessons in Country *X* for a 5-year period beginning January 1, 2003. These contracts are prepaid by the dance studio customers on December 31, 2002, and *R* recognizes foreign source taxable income of $500 from the prepayments (*R*'s only income in 2002). *P* takes into income its $450 distributive share of partnership taxable income. On January 1, 2003, *P*'s basis in its partnership interest is $1,350 ($900 from its contribution under section 722, increased by its $450 distributive share of partnership income under section 705). On September 22, 2003, *P* contributes its *R* partnership interest to *S*, a newly-formed domestic corporation, in exchange for all the stock of *S*. Under section 358, *P*'s basis in *S* is $1,350. On December 1, 2003, *P* sells *S* to an unrelated party for $1050 and recognizes a $300 loss.

(ii) *Loss allocation*. *P* recognized foreign source income for tax purposes before the income had economically accrued, and the accelerated recognition of income increased *P*'s basis in *R* without increasing its value by a corresponding amount, which resulted in the creation of a built-in loss with respect to the *S* stock. Under paragraph (b)(4)(iii) of this section the $300 loss is allocated against foreign source income if *P* had a principal purpose of recognizing foreign source income and corresponding loss.

(c) *Loss recognized by partnership*. A partner's distributive share of loss recognized by a partnership shall be allocated and apportioned in accordance with this section as if the partner had recognized the loss. If loss is attributable to an office or other fixed place of business of the partnership within the meaning of section 865(e)(3), such office or fixed place of business shall be considered to be an office of the partner for purposes of this section.

(d) *Definitions*—(1) *Terms defined in § 1.861–8*. See § 1.861–8 for the meaning of *class of gross income*, *statutory grouping of gross income*, and *residual grouping of gross income*.

(2) *Dividend recapture amount*. A dividend recapture amount is a dividend (except for an amount treated as a dividend under section 78), an inclusion described in section 951(a)(1)(A)(i) (but only to the extent attributable to a dividend (including a dividend under section 964(e)(1)) included in the earnings of a controlled foreign corporation (held directly or indirectly by the person recognizing the loss) that is included in foreign personal holding company income under section 954(c)(1)(A)) and an inclusion described in section 951(a)(1)(B).

(3) *Recapture period*. A recapture period is the 24-month period ending on the date on which a taxpayer recognized a loss with respect to stock. For example, if a taxpayer recognizes a loss on March 15, 2002, the recapture period begins on and includes March 16, 2000, and ends on and includes March 15, 2002. A recapture period is increased by any period of time in which the taxpayer has diminished its risk of loss in a manner described in section 246(c)(4) and the regulations thereunder and by any period in which the assets of the corporation are hedged against risk of loss (or are converted into and held as low-risk investments) with a principal purpose of enabling the taxpayer to hold the stock without significant risk of loss until the recapture period has expired. In the case of a loss recognized after a dividend is declared but before such dividend is paid, the recapture period is extended through the date on which the dividend is paid.

(4) *United States resident*. See section 865(g) and the regulations thereunder for the definition of United States resident.

(e) *Effective date*—(1) *In general*. This section is applicable to loss recognized on or after January 11, 1999, except that paragraphs (a)(3)(ii), (b)(1)(iv) *Example 6*, (b)(4)(iii), (b)(4)(iv) *Example 3*, and (d)(3) of this section are applicable to loss recognized on or after January 8, 2002. For purposes of this paragraph (e), loss that is recognized but deferred (for example, under section 267 or 1092) shall be treated as recognized at the time the loss is taken into account.

(2) *Application to prior periods*. A taxpayer may apply the rules of this section to losses recognized in any taxable year beginning on or after January 1, 1987, and all subsequent years, provided that—

(i) The taxpayer's tax liability as shown on an original or amended tax return is consistent with the rules of this section for each such year for which the statute of limitations does

not preclude the filing of an amended return on June 30, 2002; and

(ii) The taxpayer makes appropriate adjustments to eliminate any double benefit arising from the application of this section to years that are not open for assessment.

(3) *Examples*. The rules of this paragraph (e) may be illustrated by the following examples:

Example 1. (i) *P*, a domestic corporation, has a calendar taxable year. On March 10, 1985, *P* recognizes a $100 capital loss on the sale of *N*, a foreign corporation. Pursuant to sections 1211(a) and 1212(a), the loss is not allowed in 1985 and is carried over to the 1990 taxable year. The loss is allocated against foreign source income under § 1.861–8(e)(7). In 1999, *P* chooses to apply this section to all losses recognized in its 1987 taxable year and in all subsequent years.

(ii) Allocation of the loss on the sale of *N* is not affected by the rules of this section because the loss was recognized in a taxable year that did not begin after December 31, 1986.

Example 2. (i) *P*, a domestic corporation, has a calendar taxable year. On March 10, 1988, *P* recognizes a $100 capital loss on the sale of *N*, a foreign corporation. Pursuant to sections 1211(a) and 1212(a), the loss is not allowed in 1988 and is carried back to the 1985 taxable year. The loss is allocated against foreign source income under § 1.861–8(e)(7) on *P*'s federal income tax return for 1985 and increases an overall foreign loss account under § 1.904(f)-1.

(ii) In 1999, *P* chooses to apply this section to all losses recognized in its 1987 taxable year and in all subsequent years. Consequently, the loss on the sale of *N* is allocated against U.S. source income under paragraph (a)(1) of this section. Allocation of the loss against U.S. source income reduces *P's* overall foreign loss account and increases *P's* tax liability in 2 years: 1990, a year that will not be open for assessment on June 30, 1999, and 1997, a year that will be open for assessment on June 30, 1999. Pursuant to paragraph (e)(2)(i) of this section, *P* must file an amended federal income tax return that reflects the rules of this section for 1997, but not for 1990.

Example 3. (i) *P*, a domestic corporation, has a calendar taxable year. On March 10, 1989, *P* recognizes a $100 capital loss on the sale of *N*, a foreign corporation. The loss is allocated against foreign source income under § 1.861–8(e)(7) on *P's* federal income tax return for 1989 and results in excess foreign tax credits for that year. The excess credit is carried back to 1988, pursuant to section 904(c). In 1999, *P* chooses to apply this section to all losses recognized in its 1989 taxable year and in all subsequent years. On June 30, 1999, *P's* 1988 taxable year is closed for assessment, but *P's* 1989 taxable year is open with respect to claims for refund.

(ii) Because *P* chooses to apply this section to its 1989 taxable year, the loss on the sale of *N* is allocated against U.S. source income under paragraph (a)(1) of this section. Allocation of the loss against U.S. source income would have permitted the foreign tax credit to be used in 1989, reducing *P's* tax liability in 1989. Nevertheless, under paragraph (e)(2)(ii) of this section, because the credit was carried back to 1988, *P* may not claim the foreign tax credit in 1989.

[T.D. 8805, 64 FR 1511, Jan. 11, 1999, as amended by T.D. 8973, 66 FR 67085, Dec. 28, 2001; 67 FR 3812, Jan. 28, 2002]

NONRESIDENT ALIENS AND FOREIGN CORPORATIONS

NONRESIDENT ALIEN INDIVIDUALS

§ 1.871–1 Classification and manner of taxing alien individuals.

(a) *Classes of aliens*. For purposes of the income tax, alien individuals are divided generally into two classes, namely, resident aliens and nonresident aliens. Resident alien individuals are, in general, taxable the same as citizens of the United States; that is, a resident alien is taxable on income derived from all sources, including sources without the United States. See § 1.1–1(b). Nonresident alien individuals are taxable only on certain income from sources within the United States and on the income described in section 864(c)(4) from sources without the United States which is effectively connected for the taxable year with the conduct of a trade or business in the United States. However, nonresident alien individuals may elect, under section 6013 (g) or (h), to be treated as U.S. residents for purposes of determining their income tax liability under Chapters 1, 5, and 24 of the code. Accordingly, any reference in §§ 1.1–1 through 1.1388–1 and §§ 1.1491–1 through 1.1494–1 of this part to non-resident alien individuals does not include those with respect to whom an election under section 6013 (g) or (h) is in effect, unless otherwise specifically provided. Similarly, any reference to resident aliens or U.S. residents includes those with respect to whom an election is in effect, unless otherwise specifically provided.

(b) *Classes of nonresident aliens*—(1) *In general*. For purposes of the income tax, nonresident alien individuals are divided into the following three classes:

(i) Nonresident alien individuals who at no time during the taxable year are engaged in a trade or business in the United States,

(ii) Nonresident alien individuals who at any time during the taxable year are, or are deemed under § 1.871–9 to be, engaged in a trade or business in the United States, and

(iii) Nonresident alien individuals who are bona fide residents of a section 931 possession (as defined in § 1.931–1(c)(1) of this chapter) or Puerto Rico during the entire taxable year. An individual described in paragraph (b)(1)(i) or (ii) of this section is subject to tax pursuant to the provisions of subpart A (section 871 and following), part II, subchapter N, chapter 1 of the Code, and the regulations under those provisions. The provisions of subpart A do not apply to individuals described in this paragraph (b)(1)(iii), but such individuals, except as provided in section 931 or 933, are subject to the tax imposed by section 1 or 55. See § 1.876–1.

(2) *Treaty income*. If the gross income of a nonresident alien individual described in subparagraph (1) (i) or (ii) of this paragraph includes income on which the tax is limited by tax convention, see § 1.871–12.

(3) *Exclusions from gross income*. For rules relating to the exclusion of certain items from the gross income of a nonresident alien individual, including annuities excluded under section 871(f), see §§ 1.872–2 and 1.894–1.

(4) *Expatriation to avoid tax*. For special rules applicable in determining the tax of a nonresident alien individual who has lost U.S. citizenship with a principal purpose of avoiding certain taxes, see section 877.

(5) *Adjustment of tax of certain nonresident aliens*. For the application of pre-1967 income tax provisions to residents of a foreign country which imposes a more burdensome income tax than the United States, and for the adjustment of the income tax of a national or resident of a foreign country which imposes a discriminatory income tax on the income of citizens of the United States or domestic corporations, see section 896.

(6) *Conduit financing arrangements*. For rules regarding conduit financing arrangements, see §§ 1.881–3 and 1.881–4.

(c) *Effective/applicability date*. This section shall apply for taxable years beginning after December 31, 1966. For corresponding rules applicable to taxable years beginning before January 1, 1967, see 26 CFR 1.871–1 and 1.871–7(a) (Revised as of January 1, 1971). Paragraph (b)(1)(iii) of this section applies to taxable years ending after April 9, 2008.

[T.D. 7332, 39 FR 44218, Dec. 23, 1974, as amended by T.D. 7670, 45 FR 6928, Jan. 31, 1980; T.D. 8611, 60 FR 41004, Aug. 11, 1995; T.D. 9194, 70 FR 18928, Apr. 11, 2005; T.D. 9391, 73 FR 19358, Apr. 9, 2008]

§ 1.871–2 Determining residence of alien individuals.

(a) *General*. The term *nonresident alien individual* means an individual whose residence is not within the United States, and who is not a citizen of the United States. The term includes a nonresident alien fiduciary. For such purpose the term fiduciary shall have the meaning assigned to it by section 7701(a)(6) and the regulations in part 301 of this chapter (Regulations on Procedure and Administration). For presumption as to an alien's nonresidence, see paragraph (b) of § 1.871–4.

(b) *Residence defined*. An alien actually present in the United States who is not a mere transient or sojourner is a resident of the United States for purposes of the income tax. Whether he is a transient is determined by his intentions with regard to the length and nature of his stay. A mere floating intention, indefinite as to time, to return to another country is not sufficient to constitute him a transient. If he lives in the United States and has no definite intention as to his stay, he is a resident. One who comes to the United States for a definite purpose which in its nature may be promptly accomplished is a transient; but, if his purpose is of such a nature that an extended stay may be necessary for its accomplishment, and to that end the alien makes his home temporarily in the United States, he becomes a resident, though it may be his intention at

all times to return to his domicile abroad when the purpose for which he came has been consummated or abandoned. An alien whose stay in the United States is limited to a definite period by the immigration laws is not a resident of the United States within the meaning of this section, in the absence of exceptional circumstances.

(c) *Application and effective dates.* Unless the context indicates otherwise, §§ 1.871–2 through 1.871–5 apply to determine the residence of aliens for taxable years beginning before January 1, 1985. To determine the residence of aliens for taxable years beginning after December 31, 1984, see section 7701(b) and §§ 301.7701(b)–1 through 301.7701(b)–9 of this chapter. However, for purposes of determining whether an individual is a qualified individual under section 911(d)(1)(A), the rules of §§ 1.871–2 and 1.871–5 shall continue to apply for taxable years beginning after December 31, 1984. For purposes of determining whether an individual is a resident of the United States for estate and gift tax purposes, see § 20.0–1(b) (1) and (2) and § 25.2501–1(b) of this chapter, respectively.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 8411, 57 FR 15241, Apr. 27, 1992]

§ 1.871–3 Residence of alien seamen.

In order to determine whether an alien seaman is a resident of the United States for purposes of the income tax, it is necessary to decide whether the presumption of nonresidence (as prescribed by paragraph (b) of § 1.871–4) is overcome by facts showing that he has established a residence in the United States. Residence may be established on a vessel regularly engaged in coastwise trade, but the mere fact that a sailor makes his home on a vessel which is flying the United States flag and is engaged in foreign trade is not sufficient to establish residence in the United States, even though the vessel, while carrying on foreign trade, touches at American ports. An alien seaman may acquire an actual residence in the United States within the rules laid down in § 1.871–4, although the nature of his calling requires him to be absent for a long period from the place where his residence is established. An alien seaman may acquire such a residence at a sailors' boarding house or hotel, but such a claim should be carefully scrutinized in order to make sure that such residence is bona fide. The filing of Form 1078 or taking out first citizenship papers is proof of residence in the United States from the time the form is filed or the papers taken out, unless rebutted by other evidence showing an intention to be a transient.

§ 1.871–4 Proof of residence of aliens.

(a) *Rules of evidence.* The following rules of evidence shall govern in determining whether or not an alien within the United States has acquired residence therein for purposes of the income tax.

(b) *Nonresidence presumed.* An alien by reason of his alienage, is presumed to be a nonresident alien.

(c) *Presumption rebutted*—(1) *Departing alien.* In the case of an alien who presents himself for determination of tax liability before departure from the United States, the presumption as to the alien's nonresidence may be overcome by proof—

(i) That the alien, at least six months before the date he so presents himself, has filed a declaration of his intention to become a citizen of the United States under the naturalization laws; or

(ii) That the alien, at least six months before the date he so presents himself, has filed Form 1078 or its equivalent; or

(iii) Of acts and statements of the alien showing a definite intention to acquire residence in the United States or showing that his stay in the United States has been of such an extended nature as to constitute him a resident.

(2) *Other aliens.* In the case of other aliens, the presumption as to the alien's nonresidence may be overcome by proof—

(i) That the alien has filed a declaration of his intention to become a citizen of the United States under the naturalization laws; or

(ii) That the alien has filed Form 1078 or its equivalent; or

(iii) Of acts and statements of the alien showing a definite intention to acquire residence in the United States

or showing that his stay in the United States has been of such an extended nature as to constitute him a resident.

(d) *Certificate*. If, in the application of paragraph (c)(1)(iii) or (2)(iii) of this section, the internal revenue officer or employee who examines the alien is in doubt as to the facts, such officer or employee may, to assist him in determining the facts, require a certificate or certificates setting forth the facts relied upon by the alien seeking to overcome the presumption. Each such certificate, which shall contain, or be verified by, a written declaration that it is made under the penalties of perjury, shall be executed by some credible person or persons, other than the alien and members of his family, who have known the alien at least six months before the date of execution of the certificate or certificates.

§ 1.871–5 Loss of residence by an alien.

An alien who has acquired residence in the United States retains his status as a resident until he abandons the same and actually departs from the United States. An intention to change his residence does not change his status as a resident alien to that of a nonresident alien. Thus, an alien who has acquired a residence in the United States is taxable as a resident for the remainder of his stay in the United States.

§ 1.871–6 Duty of witholding agent to determine status of alien payees.

For the obligation of a witholding agent to withold the tax imposed by this section, see chapter 3 of the Internal Revenue Code and the regulations thereunder.

[T.D. 8734, 62 FR 53416, Oct. 14, 1997]

§ 1.871–7 Taxation of nonresident alien individuals not engaged in U.S. business.

(a) *Imposition of tax*. (1) This section applies for purposes of determining the tax of a nonresident alien individual who at no time during the taxable year is engaged in trade or business in the United States. However, see also § 1.871–8 where such individual is a student or trainee deemed to be engaged in trade or business in the United States or where he has an election in effect for the taxable year in respect to real property income. Except as otherwise provided in § 1.871–12, a nonresident alien individual to whom this section applies is not subject to the tax imposed by section 1 or section 1201(b) but, pursuant to the provision of section 871(a), is liable to a flat tax of 30 percent upon the aggregate of the amounts determined under paragraphs (b), (c), and (d) of this section which are received during the taxable year from sources within the United States. Except as specifically provided in such paragraphs, such amounts do not include gains from the sale or exchange of property. To determine the source of such amounts, see sections 861 through 863, and the regulations thereunder.

(2) The tax of 30 percent is imposed by section 871(a) upon an amount only to the extent the amount constitutes gross income. Thus, for example, the amount of an annuity which is subject to such tax shall be determined in accordance with section 72.

(3) Deductions shall not be allowed in determining the amount subject to tax under this section except that losses from sales or exchanges of capital assets shall be allowed to the extent provided in section 871(a)(2) and paragraph (d) of this section.

(4) Except as provided in §§ 1.871–9 and 1.871–10, a nonresident alien individual not engaged in trade or business in the United States during the taxable year has no income, gain, or loss for the taxable year which is effectively connected for the taxable year with the conduct of a trade or business in the United States. See section 864(c)(1)(B) and § 1.864–3.

(5) Gains and losses which, by reason of section 871(d) and § 1.871–10, are treated as gains or losses which are effectively connected for the taxable year with the conduct of a trade or business in the United States by the nonresident alien individual shall not be taken into account in determining the tax under this section. See, for example, paragraph (c)(2) of § 1.871–10.

(6) For special rules applicable in determining the tax of certain nonresident alien individuals, see paragraph (b) of § 1.871–1.

(b) *Fixed or determinable annual or periodical income*—(1) *General rule*. The tax

of 30 percent imposed by section 871(a)(1) applies to the gross amount received from sources within the United States as fixed or determinable annual or periodical gains, profits, or income. Specific items of fixed or determinable annual or periodical income are enumerated in section 871(a)(1)(A) as interest, dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, and emoluments, but other items of fixed or determinable annual or periodical gains, profits, or income are also subject to the tax, as, for instance, royalties, including royalties for the use of patents, copyrights, secret processes and formulas, and other like property. As to the determination of fixed or determinable annual or periodical income see §1.1441–2(b). For special rules treating gain on the disposition of section 306 stock as fixed or determinable annual or periodical income for purposes of section 871(a), see section 306(f) and paragraph (h) of §1.306–3.

(2) *Substitute payments.* For purposes of this section, a substitute interest payment (as defined in §1.861–2(a)(7)) received by a foreign person pursuant to a securities lending transaction or a sale-repurchase transaction (as defined in §1.861–2(a)(7)) shall have the same character as interest income paid or accrued with respect to the terms of the transferred security. Similarly, for purposes of this section, a substitute dividend payment (as defined in §1.861–3(a)(6)) received by a foreign person pursuant to a securities lending transaction or a sale-repurchase transaction (as defined in §1.861–3(a)(6)) shall have the same character as a distribution received with respect to the transferred security. Where, pursuant to a securities lending transaction or a sale-repurchase transaction, a foreign person transfers to another person a security the interest on which would qualify as portfolio interest under section 871(h) in the hands of the lender, substitute interest payments made with respect to the transferred security will be treated as portfolio interest, provided that in the case of interest on an obligation in registered form (as defined in §1.871–14(c)(1)(i)), the transferor complies with the documentation requirement described in §1.871–14(c)(1)(ii)(C) with respect to the payment of the substitute interest and none of the exceptions to the portfolio interest exemption in sections 871(h) (3) and (4) apply. See also §§1.861–2(b)(2) and 1.894–1(c).

(c) *Other income and gains*—(1) *Items subject to tax.* The tax of 30 percent imposed by section 871(a)(1) also applies to the following gains received during the taxable year from sources within the United States:

(i) Gains described in section 402(a)(2), relating to the treatment of total distributions from certain employees' trusts; section 403(a)(2), relating to treatment of certain payments under certain employee annuity plans; and section 631 (b) or (c), relating to treatment of gain on the disposal of timber, coal, or iron ore with a retained economic interest;

(ii) [Reserved]

(iii) Gains on transfers described in section 1235, relating to certain transfers of patent rights, made on or before October 4, 1966; and

(iv) Gains from the sale or exchange after October 4, 1966, of patents, copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises, or other like property, or of any interest in any such property, to the extent the gains are from payments (whether in a lump sum or in installments) which are contingent on the productivity, use or disposition of the property or interest sold or exchanged, or from payments which are treated under section 871(e) and §1.871–11 as being so contingent.

(2) *Nonapplication of 183-day rule.* The provisions of section 871(a)(2), relating to gains from the sale or exchange of capital assets, and paragraph (d)(2) of this section do not apply to the gains described in this paragraph; as a consequence, the taxpayer receiving gains described in subparagraph (1) of this paragraph during a taxable year is subject to the tax of 30 percent thereon without regard to the 183-day rule contained in such provisions.

(3) *Determination of amount of gain.* The tax of 30 percent imposed upon the gains described in subparagraph (1) of this paragraph applies to the full amount of the gains and is determined (i) without regard to the alternative tax imposed by section 1201(b) upon the

excess of the net long-term capital gain over the net short-term capital loss; (ii) without regard to the deduction allowed by section 1202 in respect of capital gains; (iii) without regard to section 1231, relating to property used in the trade or business and involuntary conversions; and (iv), except in the case of gains described in subparagraph (1)(ii) of this paragraph, whether or not the gains are considered to be gains from the sale or exchange of property which is a capital asset.

(d) *Gains from sale or exchange of capital assets*—(1) *Gains subject to tax.* The tax of 30 percent imposed by section 871(a)(2) applies to the excess of gains derived from sources within the United States over losses allocable to sources within the United States, which are derived from the sale or exchange of capital assets, determined in accordance with the provisions of subparagraphs (2) through (4) of this paragraph.

(2) *Presence in the United States 183 days or more.* (i) If the nonresident alien individual has been present in the United States for a period or periods aggregating 183 days or more during the taxable year, he is liable to a tax of 30 percent upon the amount by which his gains, derived from sources within the United States, from sales or exchanges of capital assets effected at any time during the year exceed his losses, allocable to sources within the United States, from sales or exchanges of capital assets effected at any time during that year. Gains and losses from sales or exchanges effected at any time during such taxable year are to be taken into account for this purpose even though the nonresident alien individual is not present in the United States at the time the sales or exchanges are effected. In addition, if the nonresident alien individual has been present in the United States for a period or periods aggregating 183 days or more during the taxable year, gains and losses for such taxable year from sales or exchanges of capital assets effected during a previous taxable year beginning after December 31, 1966, are to be taken into account, but only if he was also present in the United States during such previous taxable year for a period or periods aggregating 183 days or more.

(ii) If the nonresident alien individual has not been present in the United States during the taxable year, or if he has been present in the United States for a period or periods aggregating less than 183 days during the taxable year, gains and losses from sales or exchanges of capital assets effected during the year are not to be taken into account, except as required by paragraph (c) of this section, in determining the tax of such individual even though the sales or exchanges are effected during his presence in the United States. Moreover, gains and losses for such taxable year from sales or exchanges of capital assets effected during a previous taxable year beginning after December 31, 1966, are not to be taken into account, even though the nonresident alien individual was present in the United States during such previous year for a period or periods aggregating 183 days or more.

(iii) For purposes of this subparagraph, a nonresident alien individual is not considered to be present in the United States by reason of the presence in the United States of a person who is an agent or partner of such individual or who is a fiduciary of an estate or trust of which such individual is a beneficiary or a grantor-owner to whom section 671 applies.

(iv) The application of this subparagraph may be illustrated by the following examples:

Example 1. B, a nonresident alien individual not engaged in trade or business in the United States and using the calendar year as the taxable year, is present in the United States from May 1, 1971, to November 15, 1971, a period of more than 182 days. While present in the United States, B effects for his own account on various dates a number of transactions in stocks and securities on the stock exchange, as a result of which he has recognized capital gains of $10,000. During the period from January 1, 1971, to April 30, 1971, he carries out similar transactions through an agent in the United States, as a result of which B has recognized capital gains of $5,000. On December 15, 1971, through an agent in the United States B sells a capital asset on the installment plan, no payments being made by the purchaser in 1971. During 1972, B receives installment payments of $50,000 on the installment sale made in 1971, and the capital gain from sources

within the United States for 1972 attributable to such payments is $12,500. In addition, during the period from January 1, 1972, to May 31, 1972, B effects for his own account, through an agent in the United States, a number of transactions in stocks and securities on the stock exchange, as a result of which B has recognized capital gains of $20,000. At no time during 1972 is B present in the United States or engaged in trade or business in the United States. Accordingly, for 1971, B is subject to tax under section 871(a)(2) on his capital gains of $15,000 from the transactions in that year on the stock exchange. For 1972, B is not subject to tax on the capital gain of $12,500 from the installment sale in 1971 or on the capital gains of $20,000 from the transactions in 1972 on the stock exchange.

Example 2. The facts are the same as in example 1 except that B is present in the United States from June 15, 1972, to December 31, 1972, a period of more than 182 days. Accordingly, B is subject to tax under section 871(a)(2) for 1971 on his capital gains of $15,000 from the transactions in that year on the stock exchange. He is also subject to tax under section 871(a)(2) for 1972 on his capital gains of $32,500 ($12,500 from the installment sale in 1971 plus $20,000 from the transactions in 1972 on the stock exchange).

Example 3. D, a nonresident alien individual not engaged in trade or business in the United States and using the calendar year as the taxable year, is present in the United States from April 1, 1971, to August 31, 1971, a period of less than 183 days. While present in the United States, D effects for his own account on various dates a number of transactions in stocks and securities on the stock exchange, as a result of which he has recognized capital gains of $15,000. During the period from January 1, 1971, to March 31, 1971, he carries out similar transactions through an agent in the United States, as a result of which D has recognized capital gains of $8,000. On December 20, 1971, through an agent in the United States D sells a capital asset on the installment plan, no payments being made by the purchaser in 1971. During 1972, D receives installment payments of $200,000 on the installment sale made in 1971, and the capital gain from sources within the United States for 1972 attributable to such payments is $50,000. In addition, during the period from February 1, 1972, to August 15, 1972, a period of more than 182 days. D effects for his own account, through an agent in the United States, a number of transactions in stocks and securities on the stock exchange, as a result of which D has recognized capital gains of $25,000. At no time during 1972 is D present in the United States or engaged in trade or business in the United States. Accordingly, D is not subject to tax for 1971 or 1972 on any of his recognized capital gains.

Example 4. The facts are the same as in example 3 except that D is present in the United States from February 1, 1972, to August 15, 1972, a period of more than 182 days. Accordingly, D is not subject to tax for 1971 on his capital gains of $23,000 from the transactions in that year on the stock exchange. For 1972 he is subject to tax under section 871(a)(2) on his capital gains of $25,000 from the transactions in that year on the stock exchange, but he is not subject to the tax on the capital gain of $50,000 from the installment sale in 1971.

(3) *Determination of 183-day period*—(i) *In general.* In determining the total period of presence in the United States for a taxable year for purposes of subparagraph (2) of this paragraph, all separate periods of presence in the United States during the taxable year are to be aggregated. If the nonresident alien individual has not previously established a taxable year, as defined in section 441(b), he shall be treated as having a taxable year which is the calendar year, as defined in section 441(d). Subsequent adoption by such individual of a fiscal year as the taxable year will be treated as a change in the taxpayer's annual accounting period to which section 442 applies, and the change must be authorized under this part (Income Tax Regulations) or prior approval must be obtained by filing an application on Form 1128 in accordance with paragraph (b) of §1.442–1. If in the course of his taxable year the nonresident alien individual changes his status from that of a citizen or resident of the United States to that of a nonresident alien individual, or vice versa, the determination of whether the individual has been present in the United States for 183 days or more during the taxable year shall be made by taking into account the entire taxable year, and not just that part of the taxable year during which he has the status of a nonresident alien individual.

(ii) *Definition of ''day''.* The term ''day'', as used in subparagraph (2) of this paragraph, means a calendar day during any portion of which the nonresident alien individual is physically present in the United States (within the meaning of sections 7701(a)(9) and 638) except that, in the case of an individual who is a resident of Canada or Mexico and, in the normal course of his employment in transportation service

touching points within both Canada or Mexico and the United States, performs personal services in both the foreign country and the United States, the following rules shall apply:

(*a*) The performance of labor or personal services during 8 hours or more in any 1 day within the United States shall be considered as 1 day in the United States, except that if a period of more or less than 8 hours is considered a full workday in the transportation job involved, such period shall be considered as 1 day within the United States.

(*b*) The performance of labor or personal services during less than 8 hours in any day in the United States shall, except as provided in (*a*) of this subdivision, be considered as a fractional part of a day in the United States. The total number of hours during which such services are performed in the United States during the taxable year, when divided by eight, shall be the number of days during which such individual shall be considered present in the United States during the taxable year.

(*c*) The aggregate number of days determined under (*a*) and (*b*) of this subdivision shall be considered the total number of days during which such individual is present in the United States during the taxable year.

(4) *Determination of amount of excess gains*—(i) *In general*. For the purpose of determining the excess of gains over losses subject to tax under this paragraph, gains and losses shall be taken into account only if, and to the extent that, they would be recognized and taken into account if the nonresident alien individual were engaged in trade or business in the United States during the taxable year and such gains and losses were effectively connected for such year with the conduct of a trade or business in the United States by such individual. However, in determining such excess of gains over losses no deduction may be taken under section 1202, relating to the deduction for capital gains, or section 1212, relating to the capital loss carryover. Thus, for example, in determining such excess gains all amounts considered under chapter 1 of the Code as gains or losses from the sale or exchange of capital assets shall be taken into account, except those gains which are described in section 871(a)(1) (B) or (D) and taken into account under paragraph (c) of this section and are considered to be gains from the sale or exchange of capital assets. Also, for example, a loss described in section 631 (b) or (c) which is considered to be a loss from the sale of a capital asset shall be taken into account in determining the excess gains which are subject to tax under this paragraph. In further illustration, in determining such excess gains no deduction shall be allowed, pursuant to the provisions of section 267, for losses from sales or exchanges of property between related taxpayers. Any gains which are taken into account under section 871(a)(1) and paragraph (c) of this section shall not be taken into account in applying section 1231 for purposes of this paragraph. Gains and losses are to be taken into account under this paragraph whether they are short-term or long-term capital gains or losses within the meaning of section 1222.

(ii) *Gains not included*. The provisions of this paragraph do not apply to any gains described in section 871(a)(1) (B) or (D), and in subdivision (i), (iii), or (iv) of paragraph (c)(1) of this section, which are considered to be gains from the sale or exchange of capital assets.

(iii) *Allowance of losses*. In determining the excess of gains over losses subject to tax under this paragraph losses shall be allowed only to the extent provided by section 165(c). Losses from sales or exchanges of capital assets in excess of gains from sales or exchanges of capital assets shall not be taken into account.

(e) *Credits against tax*. The credits allowed by section 31 (relating to tax withheld on wages), by section 32 (relating to tax withheld at source on nonresident aliens), by section 39 (relating to certain uses of gasoline and lubricating oil), and by section 6402 (relating to overpayments of tax) shall be allowed against the tax of a nonresident alien individual determined in accordance with this section.

(f) *Effective date*. Except as otherwise provided in this paragraph, this section shall apply for taxable years beginning after December 31, 1966. Paragraph (b)(2) of this section is applicable to

payments made after November 13, 1997. For corresponding rules applicable to taxable years beginning before January 1, 1967, see 26 CFR 1.871–7 (b) and (c) (Revised as of January 1, 1971).

[T.D. 7332, 39 FR 44219, Dec. 23, 1974, as amended by T.D. 8734, 62 FR 53416, Oct. 14, 1997; T.D. 8735, 62 FR 53501, Oct. 14, 1997]

§ 1.871–8 Taxation of nonresident alien individuals engaged in U.S. business or treated as having effectively connected income.

(a) *Segregation of income.* This section applies for purposes of determining the tax of a nonresident alien individual who at any time during the taxable year is engaged in trade or business in the United States. It also applies for purposes of determining the tax of a nonresident alien student or trainee who is deemed under section 871(c) and § 1.871–9 to be engaged in trade or business in the United States or of a nonresident alien individual who at no time during the taxable year is engaged in trade or business in the United States but has an election in effect for the taxable year under section 871(d) and § 1.871–10 in respect to real property income. A nonresident alien individual to whom this section applies must segregate his gross income for the taxable year into two categories, namely (1) the income which is effectively connected for the taxable year with the conduct of a trade or business in the United States by that individual, and (2) the income which is not effectively connected for the taxable year with the conduct of a trade or business in the United States by that individual. A separate tax shall then be determined upon each such category of income, as provided in paragraph (b) of this section. The determination of whether income or gain is or is not effectively connected for the taxable year with the conduct of a trade or business in the United States by the nonresident alien individual shall be made in accordance with section 864(*c*) and §§ 1.864–3 through 1.864–7. For purposes of this section income which is effectively connected for the taxable year with the conduct of a trade or business in the United States includes all income which is treated under section 871 (c) or (d) and § 1.871–9 or § 1.871–10 as income which is effectively connected for such year with the conduct of a trade or business in the United States by the nonresident alien individual.

(b) *Imposition of tax*—(1) *Income not effectively connected with the conduct of a trade or business in the United States.* If a nonresident alien individual who is engaged in trade or business in the United States at any time during the taxable year derives during such year from sources within the United States income or gains described in section 871(a)(1), and paragraph (b) or (c) of § 1.871–7 or gains from the sale or exchange of capital assets determined as provided in section 871(a)(2) and paragraph (d) of § 1.871–7, which are not effectively connected for the taxable year with the conduct of a trade or business in the United States by that individual, such income or gains shall be subject to a flat tax of 30 percent of the aggregate amount of such items. This tax shall be determined in the manner, and subject to the same conditions, set forth in § 1.871–7 as though the income or gains were derived by a nonresident alien individual not engaged in trade or business in the United States during the taxable year, except that (i) the rule in paragraph (d)(3) of such section for treating the calendar year as the taxable year shall not apply and (ii) in applying paragraph (c) and (d)(4) of such section, there shall not be taken into account any gains or losses which are taken into account in determining the tax under section 871(b) and subparagraph (2) of this paragraph. A nonresident alien individual who has an election in effect for the taxable year under section 871(d) and § 1.871–10 and who at no time during the taxable year is engaged in trade or business in the United States must determine his tax under § 1.871–7 on his income which is not treated as effectively connected with the conduct of a trade or business in the United States, subject to the exception contained in subdivision (ii) of this subparagraph.

(2) *Income effectively connected with the conduct of a trade or business in the United States*—(i) *In general.* If a nonresident alien to whom this section applies derives income or gains which are

effectively connected for the taxable year with the conduct of a trade or business in the United States by that individual, the taxable income or gains shall, except as provided in § 1.871–12, be taxed in accordance with section 1 or, in the alternative, section 1201(b). See section 871(b)(1). Any income of the nonresident alien individual which is not effectively connected for the taxable year with the conduct of a trade or business in the United States by that individual shall not be taken into account in determining either the rate or amount of such tax. See paragraph (b) of § 1.872–1.

(ii) *Determination of taxable income.* The taxable income for any taxable year for purposes of this subparagraph consists only of the nonresident alien individual's taxable income which is effectively connected for the taxable year with the conduct of a trade or business in the United States by that individual; and, for this purpose, it is immaterial that the trade or business with which that income is effectively connected is not the same as the trade or business carried on in the United States by that individual during the taxable year. See example 2 in § 1.864–4(b). In determining such taxable income all amounts constituting, or considered to be, gains or losses for the taxable year from the sale or exchange of capital assets shall be taken into account if such gains or losses are effectively connected for the taxable year with the conduct of a trade or business in the United States by that individual, and, for such purpose, the 183-day rule set forth in section 871(a)(2) and paragraph (d)(2) of § 1.871–7 shall not apply. Losses which are not effectively connected for the taxable year with the conduct of a trade or business in the United States by that individual shall not be taken into account in determining taxable income under this subdivision, except as provided in section 873(b)(1).

(iii) *Cross references.* For rules for determining the gross income and deductions for the taxable year, see sections 872 and 873, and the regulations thereunder.

(c) *Change in trade or business status*—(1) *In general.* The determination as to whether a nonresident alien individual is engaged in trade or business within the United States during the taxable year is to be made for each taxable year. If at any time during the taxable year he is engaged in a trade or business in the United States, he is considered to be engaged in trade or business within the United States during the taxable year for purposes of sections 864(c)(1) and 871(b), and the regulations thereunder. Income, gain, or loss of a nonresident alien individual is not treated as being effectively connected for the taxable year with the conduct of a trade or business in the United States if he is not engaged in trade or business within the United States during such year, even though such income, gain, or loss may have been effectively connected for a previous taxable year with the conduct of a trade or business in the United States. See § 1.864–3. However, income, gain, or loss which is treated as effectively connected for the taxable year with the conduct of a trade or business in the United States by a nonresident alien individual will generally be treated as effectively connected for a subsequent taxable year if he is engaged in a trade or business in the United States during such subsequent year, even though such income, gain, or loss is not effectively connected with the conduct of the trade or business carried on in the United States during such subsequent year. This subparagraph does not apply to income described in section 871 (c) or (d). It may not apply to a nonresident alien individual who for the taxable year uses an accrual method of accounting or to income which is constructively received in the taxable year within the meaning of § 1.451–2.

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

Example 1. B, a nonresident alien individual using the calendar year as the taxable year and the cash receipts and disbursements method of accounting, is engaged in business (business R) in the United States from January 1, 1971, to August 31, 1971. During the period of September 1, 1971, to December 31, 1971, B receives installment payments of $30,000 on sales made in the United States by business R during that year, and the income from sources within the United States for that year attributable to such payments is

$7,509. On September 15, 1971, another business (business S), which is carried on by B only in a foreign country sells to U.S. customers on the installment plan several pieces of equipment from inventory. During the period of September 16, 1971, to December 31, 1971, B receives installment payments of $50,000 on these sales by business S, and the income from sources within the United States for that year attributable to such payments is $10,000. Under section 864(c)(3) and paragraph (b) of § 1.864–4 the entire income of $17,500 is effectively connected for 1971 with the conduct of a business in the United States by B. Accordingly, such income is taxable to B under paragraph (b)(2) of this section.

Example 2. Assume the same facts as in example 1, except that during 1972 B receives installment payments of $20,000 from the sales made during 1971 in the United States by business R, and of $80,000 from the sales made in 1971 to U.S. customers by business S, the total income from sources within the United States for 1972 attributable to such payments being $13,000. At no time during 1972 is B engaged in a trade or business in the United States. Under section 864(c)(1)(B) the income of $13,000 for 1972 is not effectively connected with the conduct of a trade or business in the United States by B. Moreover, such income is not fixed or determinable annual or periodical income. Accordingly, no amount of such income is taxable to B under section 871.

Example 3. Assume the same facts as in example 2, except that during 1972 B is engaged in a new business (business T) in the United States from July 1, 1972, to December 31, 1972. Under section 864(c)(3) and paragraph (b) of § 1.864–4, the income of $13,000 is effectively connected for 1972 with the conduct of a business in the United States by B. Accordingly, such income is taxable to B under paragraph (b)(2) of this section.

Example 4. Assume the same facts as in example 2, except that the installment payments of $20,000 from the sales made during 1971 in the United States by business R and not received by B until 1972 could have been received by B in 1971 if he had so desired. Under § 1.451–2, B is deemed to have constructively received the payments of $20,000 in 1971. Accordingly, the income attributable to such payments is effectively connected for 1971 with the conduct of a business in the United States by B and is taxable to B in 1971 under paragraph (b)(2) of this section.

(d) *Credits against tax.* The credits allowed by section 31 (relating to tax withheld on wages), section 32 (relating to tax withheld at source on nonresident aliens), section 33 (relating to the foreign tax credit), section 35 (relating to partially tax-exempt interest), section 38 (relating to investment in certain depreciable property), section 39 (relating to certain uses of gasoline and lubricating oil), section 40 (relating to expenses of work incentive programs), and section 6402 (relating to overpayments of tax) shall be allowed against the tax determined in accordance with this section. However, the credits allowed by sections 33, 38, and 40 shall not be allowed against the flat tax of 30 percent imposed by section 871(a) and paragraph (b)(1) of this section. Moreover, no credit shall be allowed under section 35 to a non- resident alien individual with respect to whom a tax is imposed for the taxable year under section 871(a) and paragraph (b)(1) of this section, even though such individual has income for such year upon which tax is imposed under section 871(b) and paragraph (b)(2) of this section. For special rules applicable in determining the foreign tax credit, see section 906(b) and the regulations thereunder. For the disallowance of certain credits where a return is not filed for the taxable year, see section 874 and § 1.874–1.

(e) *Effective date.* This section shall apply for taxable years beginning after December 31, 1966. For corresponding rules applicable to taxable years beginning before January 1, 1967, see 26 CFR 1.871–7(d) (Revised as of January 1, 1971).

[T.D. 7332, 39 FR 44221, Dec. 23, 1974]

§ 1.871–9 Nonresident alien students or trainees deemed to be engaged in U.S. business.

(a) *Participants in certain exchange or training programs.* For purposes of §§ 1.871–7 and 1.871–8 a nonresident alien individual who is temporarily present in the United States during the taxable year as a nonimmigrant under subparagraph (F) (relating to the admission of students into the United States) or subparagraph (J) (relating to the admission of teachers, trainees, specialists, etc., into the United States) of section 101(a)(15) of the Immigration and Nationality Act (8 U.S.C. 1101(a)(15) (F) or (J)), and who without regard to this paragraph is not engaged in trade or business in the United States during such year, shall be

deemed to be engaged in trade or business in the United States during the taxable year. For purposes of determining whether an alien who is present in the United States on an F visa or a J visa is a resident of the United States, see §§ 301.7701(b)–1 through 301.7701(b)–9 of this chapter.

(b) *Income treated as effectively connected with U.S. business.* Any income described in paragraph (1) (relating to the nonexcluded portion of certain scholarship or fellowship grants) or paragraph (2) (relating to certain nonexcluded expenses incident to such grants) of section 1441(b) which is received during the taxable year from sources within the United States by a nonresident alien individual described in paragraph (a) of this section is to be treated for purposes of §§ 1.871–7, 1.871–8, 1.872–1, and 1.873–1 as income which is effectively connected for the taxable year with the conduct of a trade or business in the United States by that individual. However, such income is not to be treated as effectively connected for the taxable year with the conduct of a trade or business in the United States for purposes of section 1441(c)(1) and paragraph (a) of § 1.1441–4. For exclusion relating to compensation paid to such individual by a foreign employer, see paragraph (b) of § 1.872–2.

(c) *Exchange visitors.* For purposes of paragraph (a) of this section a nonresident alien individual who is temporarily present in the United States during the taxable year as a nonimmigrant under subparagraph (J) of section 101(a)(15) of the Immigration and Nationality Act includes a nonresident alien individual admitted to the United States as an ''exchange visitor'' under section 201 of the U.S. Information and Educational Exchange Act of 1948 (22 U.S.C. 1446), which section was repealed by section 111 of the Mutual Educational and Cultural Exchange Act of 1961 (75 Stat. 538).

(d) *Mandatory application of rule.* The application of this section is mandatory and not subject to an election by the taxpayer.

(e) *Effective date.* This section shall apply for taxable years beginning after December 31, 1966. For corresponding rules applicable to taxable years beginning before January 1, 1967, see 26 CFR 1.871–7(a)(3) (Revised as of January 1, 1971).

[T.D. 7332, 39 FR 44222, Dec. 23, 1974, as amended by T.D. 8411, 57 FR 15241, Apr. 27, 1992]

§ 1.871–10 Election to treat real property income as effectively connected with U.S. business.

(a) *When election may be made.* A nonresident alien individual or foreign corporation which during the taxable year derives any income from real property which is located in the United States and, in the case of a nonresident alien individual, held for the production of income, or derives income from any interest in any such property, may elect, pursuant to section 871(d) or 882(d) and this section, to treat all such income as income which is effectively connected for the taxable year with the conduct of a trade or business in the United States by that taxpayer. The election may be made whether or not the taxpayer is engaged in trade or business in the United States during the taxable year for which the election is made or whether or not the taxpayer has income from real property which for the taxable year is effectively connected with the conduct of a trade or business in the United States, but it may be made only with respect to that income from sources within the United States which, without regard to this section, is not effectively connected for the taxable year with the conduct of a trade or business in the United States by the taxpayer. If for the taxable year the taxpayer has no income from real property located in the United States, or from any interest in such property, which is subject to the tax imposed by section 871(a) or 881(a), the election may not be made. But if an election has been properly made under this section for a taxable year, the election remains in effect, unless properly revoked, for subsequent taxable years even though during any such subsequent taxable year there is no income from the real property, or interest therein, in respect of which the election applies.

(b) *Income to which the election applies*—(1) *Included income.* An election

under this section shall apply to all income from real property which is located in the United States and, in the case of a nonresident alien individual, held for the production of income, and to all income derived from any interest in such property, including (i) gains from the sale or exchange of such property or an interest therein, (ii) rents or royalties from mines, oil or gas wells, or other natural resources, and (iii) gains described in section 631 (b) or (c), relating to treatment of gain on the disposal of timber, coal, or iron ore with a retained economic interest. The election may not be made with respect to only one class of such income. For purposes of the election, income from real property, or from any interest in real property, includes any amount included under section 652 or 662 in the gross income of a nonresident alien individual or foreign corporation that is the beneficiary of an estate or trust if, by reason of the application of section 652(b) or 662(b), and the regulations thereunder, such amount has the character in the hands of that beneficiary of income from real property, or from any interest in real property. It is immaterial that no tax would be imposed on the income by section 871(a) and paragraph (a) of §1.871–7, or by section 881(a) and paragraph (a) of §1.881–2, if the election were not in effect. Thus, for example, if an election under this section has been made by a nonresident alien individual not engaged in trade or business in the United States during the taxable year, the tax imposed by section 871(b)(1) and paragraph (b)(2) of §1.871–8 applies to his gains derived from the sale of real property located in the United States and held for the production of income, even though such income would not be subject to tax under section 871(a) if the election had not been made. In further illustration, assume that a nonresident alien individual not engaged in trade or business, or present, in the United States during the taxable year has income from sources within the United States consisting of oil royalties, rentals from a former personal residence, and capital gain from the sale of another residence held for the production of income. If he makes an election under this section, it will apply with respect to his royalties, rentals, and capital gain, even though such capital gain would not be subject to tax under section 871(a) if the election had not been made.

(2) *Income not included.* For purposes of subparagraph (1) of this paragraph, income from real property, or from any interest in real property, does not include (i) interest on a debt obligation secured by a mortgage of real property, (ii) any portion of a dividend, within the meaning of section 316, which is paid by a corporation or a trust, such as a real estate investment trust described in section 857, which derives income from real property, (iii) in the case of a nonresident alien individual, income from real property, such as a personal residence, which is not held for the production of income or from any transaction in such property which was not entered into for profit, (iv) rentals from personal property, or royalties from intangible personal property, within the meaning of subparagraph (3) of this paragraph, or (v) income which, without regard to section 871(d) or 882(d) and this section, is treated as income which is effectively connected for the taxable year with the conduct of a trade or business in the United States.

(3) *Rules applicable to personal property.* For purposes of subparagraph (2) of this paragraph, in the case of a sales agreement, or rental or royalty agreement, affecting both real and personal property, the income from the transaction is to be allocated between the real property and the personal property in proportion to their respective fair market values unless the agreement specifically provides otherwise. In the case of such a rental or royalty agreement, the respective fair market values are to be determined as of the time the agreement is signed. In making determinations of this subparagraph, the principles of paragraph (c) of §1.48–1, relating to the definition of ''section 38 property,'' apply for purposes of determining whether property is tangible or intangible personal property and of paragraph (a)(5) of §1.1245–1 apply for purposes of making the allocation of income between real and personal property.

(c) *Effect of the election*—(1) *Determination of tax.* The income to which, in accordance with paragraph (b) of this section, an election under this section applies shall be subject to tax in the manner, and subject to the same conditions, provided by section 871(b)(1) and paragraph (b)(2) of § 1.871–8, or by section 882(a)(1) and paragraph (b)(2) of § 1.882–1. For purposes of determining such tax for the taxable year, income to which the election applies shall be aggregated with all other income of the nonresident alien individual or foreign corporation which is effectively connected for the taxable year with the conduct of a trade or business in the United States by that taxpayer. To the extent that deductions are connected with income from real property to which the election applies, they shall be treated for purposes of section 873(a) or section 882(c)(1) as connected with income which is effectively connected for the taxable year with the conduct of a trade or business in the United States by the nonresident alien individual or foreign corporation. An election under this section does not cause a nonresident alien individual or foreign corporation, which is not engaged in trade or business in the United States during the taxable year, to be treated as though such taxpayer were engaged in trade or business in the United States during the taxable year. Thus, for example, the compensation received during the taxable year for services performed in the United States in a previous taxable year by a nonresident alien individual, who has an election in effect for the taxable year under this section but is engaged in trade or business in the United States at no time during the taxable year, is not effectively connected for the taxable year with the conduct of a trade or business in the United States. In further illustration, gain for the taxable year from the casual sale of personal property described in section 1221(I) derived by a nonresident alien individual who is not engaged in trade or business in the United States during the taxable year but has an election in effect for such year under this section is not effectively connected with the conduct of a trade or business in the United States. See § 1.864–3. If an election under this section is in effect for the taxable year, the income to which the election applies shall be treated, for purposes of section 871(b)(1) or section 882(a)(1), section 1441(c)(1), and paragraph (a) of § 1.1441–4, as income which is effectively connected for the taxable year with the conduct of a trade or business in the United States by the taxpayer.

(2) *Treatment of property to which election applies.* Any real property, or interest in real property, with respect to which an election under this section applies shall be treated as a capital asset which, if depreciable, is subject to the allowance for depreciation provided in section 167 and the regulations thereunder. Such property, or interest in property, shall be treated as property not used in a trade or business for purposes of applying any provisions of the Code, such as section 172(d)(4)(A), relating to gain or loss attributable to a trade or business for purposes of determining a net operating loss; section 1221(2), relating to property not constituting a capital asset; or section 1231(b), relating to special rules for treatment of gains and losses. For example, if a nonresident alien individual makes the election under this section and, while the election is in effect, sells unimproved land which is located in the United States and held for investment purposes, any gain or loss from the sale shall be considered gain or loss from the sale of a capital asset and shall be treated, for purposes of determining the tax under section 871(b)(1) and paragraph (b)(2) of § 1.871–8, as a gain or loss which is effectively connected for the taxable year with the conduct of a trade or business in the United States.

(d) *Manner of making or revoking an election*—(1) *Election, or revocation, without consent of Commissioner*—(i) *In general.* A nonresident alien individual or foreign corporation may, for the first taxable year for which the election under this section is to apply, make the initial election at any time before the expiration of the period prescribed by section 6511(a), or by section 6511(c) if the period for assessment is extended by agreement, for filing a claim for credit or refund of the tax imposed by chapter 1 of the Code for such taxable

year. This election may be made without the consent of the Commissioner. Having made the initial election, the taxpayer may, within the time prescribed for making the election for such taxable year, revoke the election without the consent of the Commissioner. If the revocation is timely and properly made, the taxpayer may make his initial election under this section for a later taxable year without the consent of the Commissioner. If the taxpayer revokes the initial election without the consent of the Commissioner he must file amended income tax returns, or claims for credit or refund, where applicable, for the taxable years to which the revocation applies.

(ii) *Statement to be filed with return.* An election made under this section without the consent of the Commissioner shall be made for a taxable year by filing with the income tax return required under section 6012 and the regulations thereunder for such taxable year a statement to the effect that the election is being made. This statement shall include (*a*) a complete schedule of all real property, or any interest in real property, of which the taxpayer is titular or beneficial owner, which is located in the United States, (*b*) an indication of the extent to which the taxpayer has direct or beneficial ownership in each such item of real property, or interest in real property, (*c*) the location of the real property or interest therein, (*d*) a description of any substantial improvements on any such property, and (*e*) an identification of any taxable year or years in respect of which a revocation or new election under this section has previously occurred. This statement may not be filed with any return under section 6851 and the regulations thereunder.

(iii) *Exemption from withholding of tax.* For statement to be filed with a withholding agent at the beginning of a taxable year in respect of which an election under this section is to be made, see paragraph (a) of § 1.1441–4.

(2) *Revocation, or election, with consent of Commissioner*—(i) *In general.* If the nonresident alien individual or foreign corporation makes the initial election under this section for any taxable year and the period prescribed by subparagraph (1)(i) of this paragraph for making the election for such taxable year has expired, the election shall remain in effect for all subsequent taxable years, including taxable years for which the taxpayer realizes no income from real property, or from any interest therein, or for which he is not required under section 6012 and the regulations thereunder to file an income tax return. However, the election may be revoked in accordance with subdivision (iii) of this subparagraph for any subsequent taxable year with the consent of the Commissioner. If the election for any such taxable year is revoked with the consent of the Commissioner, the taxpayer may not make a new election before his fifth taxable year which begins after the first taxable year for which the revocation is effective unless consent is given to such new election by the Commissioner in accordance with subdivision (iii) of this subparagraph.

(ii) *Effect of new election.* A new election made for the fifth taxable year, or taxable year thereafter, without the consent of the Commissioner, and a new election made with the consent of the Commissioner, shall be treated as an initial election to which subparagraph (1) of this paragraph applies.

(iii) *Written request required.* A request to revoke an election made under this section when such revocation requires the consent of the Commissioner, or to make a new election when such election requires the consent of the Commissioner, shall be made in writing and shall be addressed to the Director of International Operations, Internal Revenue Service, Washington, DC 20225. The request shall include the name and address of the taxpayer and shall be signed by the taxpayer or his duly authorized representative. It must specify the taxable year for which the revocation or new election is to be effective and shall be filed within 75 days after the close of the first taxable year for which it is desired to make the change. The request must specify the grounds which are considered to justify the revocation or new election. The Director of International Operations may require such other information as may be necessary in order to determine whether the proposed change will be permitted. A copy of the consent by

the Director of International Operations shall be attached to the taxpayer's return required under section 6012 and the regulations thereunder for the taxable year for which the revocation or new election is effective. A copy of such consent may not be filed with any return under section 6851 and the regulations thereunder.

(3) *Election by partnership.* If a nonresident alien individual or foreign corporation is a member of a partnership which has income described in paragraph (b)(1) of this section from real property, any election to be made under this section in respect of such income shall be made by the partners and not by the partnership. A nonresident alien or foreign corporation that makes an election generally must provide the partnership a Form W–8ECI, ''Certificate of Foreign Person's Claim for Exemption from Withholding on Income Effectively Connected with the Conduct of a Trade or Business in the United States,'' and attach to such form a copy of the election (or a statement that indicates that the nonresident alien or foreign corporation will make the election). However, if the nonresident alien or foreign corporation has already submitted a valid form to the partnership that establishes such partner's foreign status, the partner shall furnish the partnership a copy of the election (or a statement that indicates that the nonresident alien or foreign corporation will make the election). To the extent the partnership has income to which the election pertains, the partnership shall treat such income as effectively connected income subject to withholding under section 1446. See also § 1.1446–2.

(e) *Effective dates.* This section shall apply for taxable years beginning after December 31, 1966, except the last four sentences of paragraph (d)(3) of this section shall apply to partnership taxable years beginning after May 18, 2005, or such earlier time as the regulations under §§ 1.1446–1 through 1.1446–5 apply by reason of an election under § 1.1446–7. There are no corresponding rules in this part for taxable years beginning before January 1, 1967.

[T.D. 7332, 39 FR 44222, Dec. 23, 1974, as amended by T.D. 9200, 70 FR 28717, May 18, 2005]

§ 1.871–11 Gains from sale or exchange of patents, copyrights, or similar property.

(a) *Contingent payment defined.* For purposes of section 871(a)(1)(D), section 881(a)(4), § 1.871–7(c)(1)(iv), § 1.881–2(c)(1)(iii), and this section, payments which are contingent on the productivity, use, or disposition of property or of an interest therein include continuing payments measured by a percentage of the selling price of the products marketed, or based on the number of units manufactured or sold, or based in a similar manner upon production, sale or use, or disposition of the property or interest transferred. A payment which is certain as to the amount to be received, but contingent as to the time of payment, or an installment payment of a principal sum agreed upon in a transfer agreement, shall not be treated as a contingent payment for purposes of this paragraph. For the inapplication of section 1253 to certain amounts described in this paragraph, see paragraph (a) of § 1.1253–1.

(b) *Payments treated as contingent on use.* Pursuant to section 871(e), if more than 50 percent of the gain of a nonresident alien individual or foreign corporation for any taxable year from the sale or exchange after October 4, 1966, of any patent, copyright, secret process or formula, goodwill, trademark, trade brand, franchise, or other like property, or of any interest in any such property, is from payments which are contingent on the productivity, use, or disposition of such property or interest, all of the gain of such individual or corporation for the taxable year from the sale or exchange of such property or interest are, for purposes of section 871(a)(1)(D), section 881(a)(4), section 1441(b), or section 1442(a), and the regulations thereunder, to be treated as being from payments which are contingent on the productivity, use, or disposition of such property or interest. This paragraph does not apply for purposes of determining under section 871(b)(1) or 882(a)(1) the tax of a nonresident alien individual or foreign corporation on income which is effectively connected for the taxable year with the conduct of a trade or business in the United States.

(c) *Sale or exchange.* A sale or exchange for purposes of this section includes, but is not limited to, a transfer by an individual which by reason of section 1235, relating to the sale or exchange of patents, is considered the sale or exchange of a capital asset. The provisions of section 1253, relating to transfers of franchises, trademarks, and trade names, do not apply in determining whether a transfer is a sale or exchange for purposes of this section.

(d) *Recovery of adjusted basis.* For purposes of determining for any taxable year the amount of gains which are subject to tax under section 871(a)(1)(D) or 881(a)(4), payments received by the nonresident alien individual or foreign corporation during such year must be reduced by amounts representing recovery of the taxpayer's adjusted basis of the property or interest which is sold or exchanged. Where the taxpayer receives in the same taxable year payments which, without reference to section 871(e) and this section, are not contingent on the productivity, use, or disposition of the property or interest which is sold or exchanged and payments which are contingent on the productivity, use, or disposition of the property or interest which is sold or exchanged, the taxpayer's unrecovered adjusted basis in the property or interest which is sold or exchanged must be allocated for the taxable year between such payments on the basis of the gross amount of each such type of payments. Where the taxpayer receives in the taxable year only payments which are not so contingent or only payments which are so contingent, the taxpayer's unrecovered basis must be allocated in its entirety to such payments for the taxable year.

(e) *Source rule.* In determining whether gains described in section 871(a)(1)(D) or 881(a)(4) and paragraph (b) of this section are received from sources within the United States, such gains shall be treated, for purposes of section 871(a)(1)(D), section 881(a)(4), section 1441(b), and section 1442(a), as rentals or royalties for the use of, or privilege of using, property or an interest in property. See section 861(a)(4), § 1.861–5, and paragraph (a) of § 1.862–1.

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

Example 1. (a) A, a nonresident alien individual who uses the cash receipts and disbursements method of accounting and the calendar year as the taxable year, holds a U.S. patent which he developed through his own effort. On December 15, 1967, A enters into an agreement of sale with M Corporation, a domestic corporation, whereby A assigns to M Corporation all of his U.S. rights in the patent. In consideration of the sale, M Corporation is obligated to pay a fixed sum of $60,000, $20,000 being payable on execution of the contract and the balance payable in four annual installments of $10,000 each. As additional consideration, M Corporation agrees to pay to A a royalty in the amount of 2 percent of the gross sales of the products manufactured by M Corporation under the patent. A is not engaged in trade or business in the United States at any time during 1967 and 1968. His adjusted basis in the patent at the time of sale is $28,800.

(b) In 1967, A receives only the $20,000 paid by M Corporation on the execution of the contract of sale. No gain is realized by A upon receipt of this amount, and his unrecovered adjusted basis in the patent is reduced to $8,800 ($28,800 less $20,000).

(c) In 1968, M Corporation has gross sales of $600,000 from products manufactured under the patent. Consequently, for 1968, M Corporation pays $22,000 to A, $10,000 being the annual installment on the fixed payment and $12,000 being payments under the terms of the royalty provision. A's recognized gain for 1968 is $13,200 ($22,000 reduced by the unrecovered adjusted basis of $8,800). Of the total gain of $13,200, gain in the amount of $6,000 ($10,000 − [$8,800 × $10,000/$22,000]) is considered to be from the fixed installment payment and of $7,200 ($12,000 − [$8,800 × $12,000/$22,000]) is considered to be from the royalty payment. Since 54.5 percent ($7,200/$13,200) of the gain recognized in 1968 from the sale of the patent is from payments which are contingent on the productivity, use, or disposition of the patent, all of the $13,200 gain recognized in 1968 is treated, for purposes of section 871(a)(1)(D) and section 1441(b), as being from payments which are contingent on the productivity, use, or disposition of the patent.

Example 2. (a) F, a foreign corporation using the calendar year as the taxable year and not engaged in trade or business in the United States, holds a U.S. patent on certain property which it developed through its own efforts. Corporation F uses the cash receipts and disbursements method of accounting. On December 1, 1966, F Corporation enters into an agreement of sale with D Corporation, a

domestic corporation, whereby D Corporation purchases the exclusive right and license, and the right to sublicense to others, to manufacture, use, and/or sell certain devices under the patent in the United States during the term of the patent. The agreement grants D Corporation the right to dispose, anywhere in the world, of machinery manufactured in the United States and equipped with such devices. Corporation D is granted the right, at its own expense, to prosecute infringers in its own name or in the name of F Corporation, or both, and to retain any damages recovered.

(b) Corporation D agrees to pay to F Corporation annually $5 for each device manufactured under the patent during the year but in no case less than $5,000 per year. In 1967, D Corporation manufactures 2,500 devices under the patent; and, in 1968, 1,500 devices. Under the terms of the contract D Corporation pays to F Corporation in 1967 $12,500 with respect to production in that year and $7,500 in 1968 with respect to production in that year. F Corporation's basis in the patent at the time of the sale is $17,000.

(c) With respect to the payments received by F Corporation in 1967, no gain is realized by that corporation and its unrecovered adjusted basis in the patent is reduced to $4,500 ($17,000 less $12,500).

(d) With respect to the payments received by F Corporation in 1968, such corporation has recognized gain of $3,000 ($7,500 reduced by unrecovered adjusted basis of $4,500). Of the total gain of $3,000, gain in the amount of $2,000 ($5,000 − [$4,500 × $5,000/$7,500]) is considered to be from the fixed installment payment and of $1,000 ($2,500 − [$4,500 × $2,500/$7,500]) is considered to be from payments which are contingent on the productivity, use, or disposition of the patent. Since 33.3 percent ($1,000/$3,000) of the gain recognized in 1968 from the sale of the patent is from payments which are contingent on the productivity, use, or disposition of the patent, only $1,000 of the $3,000 gain for that year constitutes gains which, for purposes of section 881(a)(4) and section 1442(a), are from payments which are contingent on the productivity, use, or disposition of the patent. The balance of $2,000 is gain from the sale of property and is not subject to tax under section 881(a).

(g) *Effective date.* This section shall apply for taxable years beginning after December 31, 1966, but only in respect of gains from sales or exchanges occurring after October 4, 1966. There are no corresponding rules in this part for taxable years beginning before January 1, 1967.

[T.D. 7332, 39 FR 44224, Dec. 23, 1974]

§ 1.871–12 Determination of tax on treaty income.

(a) *In general.* This section applies for purposes of determining under § 1.871–7 or § 1.871–8 the tax of a nonresident alien individual, or under § 1.881–2 or § 1.882–1 the tax of a foreign corporation, which for the taxable year has income described in section 872(a) or 882(b) upon which the tax is limited by an income tax convention to which the United States is a party. Income for such purposes does not include income of any kind which is exempt from tax under the provisions of an income tax convention to which the United States is a party. See §§ 1.872–2(c) and 1.883–1(b). This section shall not apply to a nonresident alien individual who is a bona fide resident of Puerto Rico during the entire taxable year.

(b) *Definition of treaty and nontreaty income*—(1) *In general.* (i) For purposes of this section the term ''treaty income'' shall be construed to mean the gross income of a nonresident alien individual or foreign corporation, as the case may be, the tax on which is limited by a tax convention. The term ''non-treaty income'' shall be construed, for such purposes, to mean the gross income of the nonresident alien individual or foreign corporation other than the treaty income. Neither term includes income of any kind which is exempt from the tax imposed by chapter 1 of the Code.

(ii) In determining either the treaty or nontreaty income the gross income shall be determined in accordance with §§ 1.872–1 and 1.872–2, or with §§ 1.882–3 and 1.883–1, except that in determining the treaty income the exclusion granted by section 116(a) for dividends shall not be taken into account. Thus, for example, treaty income includes the total amount of dividends paid by a domestic corporation not disqualified by section 116(b) and received from sources within the United States if, in accordance with a tax convention, the dividends are subject to the income tax at a rate not to exceed 15 percent but does not include interest which, in accordance with a tax convention, is exempt from the income tax. In further illustration, neither the treaty nor the nontreaty income includes interest on certain governmental obligations

which by reason of section 103 is excluded from gross income, or interest which by reason of a tax convention is exempt from the tax imposed by chapter 1 of the Code.

(iii) For purposes of applying any income tax convention to which the United States is a party, original issue discount which is subject to tax under section 871(a)(1)(C) or 881(a)(3) is to be treated as interest, and gains which are subject to tax under section 871(a)(1)(D) or 881(a)(4) are to be treated as royalty income. This subdivision shall not apply, however, where its application would be contrary to any treaty obligation of the United States.

(2) *Application of permanent establishment rule of treaties.* In applying this section with respect to income which is not effectively connected for the taxable year with the conduct of a trade or business in the United States by a nonresident alien individual or foreign corporation, see section 894(b), which provides that with respect to such income the nonresident alien individual or foreign corporation shall be deemed not to have a permanent establishment in the United States at any time during the taxable year for purposes of applying any exemption from, or reduction in rate of, tax provided by any tax convention.

(c) *Determination of tax*—(1) *In general.* If the gross income of a nonresident alien individual or foreign corporation, as the case may be, consists of both treaty and nontreaty income, the tax liability for the taxable year shall be the sum of the amounts determined in accordance with subparagraphs (2) and (3) of this paragraph. In no case, however, may the tax liability so determined exceed the tax liability (tax reduced by allowable credits) with respect to the taxpayer's entire income, determined in accordance with § 1.871–7 or § 1.871–8, or with § 1.881–2 or § 1.882–1, as though the tax convention had not come into effect and without reference to the provisions of this section. Determinations under this paragraph shall be made without taking into account any credits allowed by sections 31, 32, 39, and 6402, but such credits shall be allowed against the tax liability determined in accordance with this subparagraph.

(2) *Tax on nontreaty income.* For purposes of subparagraph (1) of this paragraph, compute a partial tax (determined without the allowance of any credit) upon only the nontreaty income in accordance with § 1.871–7 or § 1.871–8, or with § 1.881–2 or § 1.882–1, whichever applies, as though the tax convention had not come into effect. To the extent allowed by paragraph (d) of § 1.871–8, or paragraph (c) of § 1.882–1, the credits allowed by sections 33, 35, 38, and 40 shall then be allowed, without taking into account any item included in the treaty income, against the tax determined under this subparagraph.

(3) *Tax on treaty income.* For purposes of subparagraph (1) of this paragraph, compute a tax upon the gross amount, determined without the allowance of any deduction, of each separate item of treaty income at the reduced rate applicable to that item under the tax convention. No credits shall be allowed against the tax determined under this subparagraph.

(d) *Illustration.* The application of this section may be illustrated by the following example:

Example. (a) A nonresident alien individual who is a resident of a foreign country with which the United States has entered into a tax convention receives during the taxable year 1967 from sources within the United States total gross income of $22,000, consisting of the following items:

Compensation for personal services the tax on which is not limited by the tax convention (effectively connected income under § 1.864–4(c)(6)(ii))	$20,000
Oil royalties the tax on which is limited by the tax convention to 15 percent of the gross amount thereof (effectively connected income by reason of election under § 1.871–10)	2,000
Total gross income	22,000

(b) The taxpayer is engaged in business in the United States during the taxable year but does not have a permanent establishment therein. There are no allowable deductions, other than the deductions allowed by sections 613 and 873(b)(3).

(c) The tax liability for the taxable year is $6,100, determined as follows:

Nontreaty gross income	$20,000
Less: Deduction for personal exemption	600
Nontreaty taxable income	19,400
Tax under section 1 of the Code on nontreaty taxable income ($5,170 plus 45 percent of $1,400)	5,800
Plus: Tax on treaty income (Gross oil royalties) ($2,000 × 15 percent)	300

Total tax (determined as provided in paragraph (c) (2) and (3) of this section)		6,100

(d) If the tax had been determined under paragraph (b)(2) of § 1.871–8 as though the tax liability would have been $6,478, determined as follows and by taking into account the election under § 1.871–10:

Total gross income	.....	$22,000
Less: Deduction under section 613 for percentage depletion ($2000 × 27½ percent)	$550	
Deduction for personal exemption ...	600	1,150
Taxable income	20,850	
Tax under section 1 of the Code on taxable income ($6,070 plus 48 percent of $850)		6,478

(e) *Effective date.* This section shall apply for taxable years beginning after December 31, 1966. For corresponding rules applicable to taxable years beginning before January 1, 1967, see 26 CFR 1.871–7(e) (Revised as of January 1, 1971).

[T.D. 7332, 39 FR 44225, Dec. 23, 1974, as amended at T.D. 8657, 61 FR 9338, Mar. 8, 1996]

§ 1.871–13 Taxation of individuals for taxable year of change of U.S. citizenship or residence.

(a) *In general.* (1) An individual who is a citizen or resident of the United States at the beginning of the taxable year but a nonresident alien at the end of the taxable year, or a nonresident alien at the beginning of the taxable year but a citizen or resident of the United States at the end of the taxable year, is taxable for such year as though his taxable year were comprised of two separate periods, one consisting of the time during which he is a citizen or resident of the United States and the other consisting of the time during which he is not a citizen or resident of the United States. Thus, for example, the income tax liability of an alien individual under chapter 1 of the Code for the taxable year in which he changes his residence will be computed under two different sets of rules, one relating to resident aliens for the period of residence and the other relating to nonresident aliens for the period of nonresidence. However, in determining the taxable income for such year which is subject to the graduated rate of tax imposed by section 1 or 1201 of the Code, all income for the period of U.S. citizenship or residence must be aggregated with the income for the period of nonresidence which is effectively connected for such year with the conduct of a trade or business in the United States. This section does not apply to alien individuals treated as residents for the entire taxable year under section 6013 (g) or (h). These individuals are taxed under the rules in § 1.1–1(b).

(2) For purposes of this section, an individual is deemed to be a citizen or resident of the United States for the day on which he becomes a citizen or resident of the United States, a nonresident of the United States for the day on which he abandons his U.S. residence, and an alien for the day on which he gives up his U.S. citizenship.

(b) *Acquisition of U.S. citizenship or residence.* Income from sources without the United States which is not effectively connected with the conduct by the taxpayer of a trade or business in the United States is not taxable if received by an alien individual while he is not a resident of the United States even though he becomes a citizen or resident of the United States after its receipt and before the close of the taxable year. However, income from sources without the United States which is not effectively connected with the conduct by the taxpayer of a trade or business in the United States is taxable if received by an individual while he is a citizen or resident of the United States, even though he earns the income earlier in the taxable year while he is neither a citizen nor resident of the United States.

(c) *Abandonment of U.S. citizenship or residence.* Income from sources without the United States which is not effectively connected with the conduct by the taxpayer of a trade or business in the United States is not taxable if received by an alien individual while he is not a resident of the United States, even though he earns the income earlier in the taxable year while he is a citizen or resident of the United States. However, income from sources without the United States which is not effectively connected with the conduct by the taxpayer of a trade or business in the United States is taxable if received by an individual while he is a citizen or resident of the United States, even though he abandons his

U.S. citizenship or residence after its receipt and before the close of the taxable year.

(d) *Special rules*—(1) *Method of accounting*. Paragraphs (b) and (c) of this section may not apply to an individual who for the taxable year uses an accrual method of accounting.

(2) *Deductions for personal exemptions*. An alien individual to whom this section applies is entitled to deduct one personal exemption for the taxable year under section 151. In addition, he is entitled to such additional exemptions as are allowed as a deduction under section 151 but only to the extent the amount of such additional exemptions do not exceed his taxable income (determined without regard to any deduction for personal exemptions) for the period in the taxable year during which he is a citizen or resident of the United States. This subparagraph does not apply to the extent it is inconsistent with section 873, and the regulations thereunder, or with the provisions of an income tax convention to which the United States is a party.

(3) *Exclusion of dividends received*. In determining the $100 exclusion for the taxable year provided by section 116 in respect of certain dividends, only those dividends for the period during which the individual is neither a citizen nor resident of the United States may be taken into account as are effectively connected for the taxable year with the conduct of a trade or business in the United States. See § 1.116–1(e)(1).

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

Example 1. A, a married alien individual who uses the calendar year as the taxable year and the cash receipts and disbursements method of accounting, becomes a resident of the United States on June 1, 1971. During the period of nonresidence from January 1, 1971, to May 31, 1971, inclusive, A receives $15,000 income from sources without the United States which is not effectively connected with the conduct of a trade or business in the United States. During the period of residence from June 1, 1971, to December 31, 1971, A receives wages of $10,000, dividends of $200 from a foreign corporation, and dividends of $75 from a domestic corporation qualifying under section 116(a). Of the amount of wages so received, $2,000 is for services performed by A outside the United States during the period of nonresidence. Total allowable deductions (other than for personal exemptions) amount to $700, none of which are deductible under section 62 in computing adjusted gross income. For 1971 A's spouse has no gross income and is not the dependent of another taxpayer. For 1971, A's taxable income is $8,200, all of which is subject to tax under section 1, as follows:

Wages		$10,000
Dividends from foreign corporation		200
Dividends from domestic corporation ($75 less $75 exclusion)		0
Adjusted gross income		10,200
Less deductions:		
Personal exemptions (2 × $650)	$1,300	
Other allowable deductions	700	2,000
Taxable income		8,200

Example 2. The facts are the same as in example 1 except that during the period of nonresidence from January 1, 1971, to May 31, 1971, A receives from sources within the United States income of $1,850 which is effectively connected with the conduct by A of a business in the United States and $350 in dividends from domestic corporations qualifying under section 116(a). Only $50 of these dividends are effectively connected with the conduct by A of a business in the United States. The assumption is made that there are no allowable deductions connected with such effectively connected income. For 1971, A has taxable income of $10,075 subject to tax under section 1 and $300 income subject to tax under section 871(a)(1)(A), as follows:

Wages		$10,000
Business income		1,850
Dividends from foreign corporation		200
Dividends from domestic corporation ($125 less $100 exclusion)		25
Adjusted gross income		12,075
Less deductions:		
Personal exemptions (2 × $650)	$1,300	
Other allowable deductions	700	2,000
Taxable income subject to tax under section 1		10,075
Income subject to tax under section 871(a)(1)(A)		300

Example 3. A, a married alien individual with three children, uses the calendar year as the taxable year and the cash receipts and disbursements method of accounting. On October 1, 1971, A and his family become residents of the United States. During the period of nonresidence from January 1, 1971, to September 30, 1971, A receives income of $18,000 from sources without the United States which is not effectively connected with the conduct of a trade or business in the United States and of $2,500 from sources within the United States which is effectively connected with the conduct of a business in the United States. It is assumed there are no allowable deductions connected with such effectively

connected income. During the period of residence from October 1, 1971, to December 31, 1971, A receives wages of $2,000, of which $400 is for services performed outside the United States during the period of nonresidence. Total allowable deductions (other than for personal exemptions) amount to $250, none of which are deductible under section 62 in computing adjusted gross income. Neither the spouse nor any of the children has any gross income for 1971, and the spouse is not the dependent of another taxpayer for such year. For 1971, A's taxable income is $1,850, all of which is subject to tax under section 1, as follows:

Wages (residence period)	$2,000	
Less: Allowable deductions	250	
Taxable income (without deduction for personal exemptions) (residence period)		$1,750
Business income (nonresidence period)		2,500
Total taxable income (without deduction for personal exemptions)		4,250
Less deduction for personal exemptions:		
Taxpayer	650	
Wife and 3 children (4 × $650, but not to exceed $1,750)	1,750	2,400
Taxable income		1,850

(f) *Effective date.* This section shall apply for taxable years beginning after December 31, 1966. There are no corresponding rules in this part for taxable years beginning before January 1, 1967.

[T.D. 7332, 39 FR 44226, Dec. 23, 1974, as amended by T.D. 7670, 45 FR 6928, Jan. 31, 1980]

§ 1.871–14 Rules relating to repeal of tax on interest of nonresident alien individuals and foreign corporations received from certain portfolio debt investments.

(a) *General rule.* No tax shall be imposed under section 871(a)(1)(A), 871(a)(1)(C), 881(a)(1) or 881(a)(3) on any portfolio interest as defined in sections 871(h)(2) and 881(c)(2) received by a foreign person. But see section 871(b) or 882(a) if such interest is effectively connected with the conduct of a trade or business within the United States.

(b) [Reserved] For further guidance, see § 1.871–14T(b).

(c) *Rules concerning obligations in registered form*—(1) *In general*—(i) *Obligation in registered form.* For purposes of this section, an obligation is in registered form only as provided in this paragraph (c)(1)(i). The conditions for an obligation to be considered in registered form are identical to the conditions described in § 5f.103–1 of this chapter. Therefore, an obligation that would be an obligation in registered form except for the fact that it can be converted at any time in the future into an obligation that is not in registered form shall not be an obligation in registered form. An obligation that is not in registered form by reason of the preceding sentence may nevertheless be in registered form, but only after the possibility of conversion is terminated. An obligation that is not in registered form and can be converted into an obligation that would meet the requirements of this paragraph (c)(1)(i) for being in registered form shall be considered in registered form only after the conversion is effected. For purposes of this section, an obligation is convertible if the obligation can be transferred by any means not described in § 5f.103–1(c) of this chapter. An obligation is treated as an obligation in registered form if—

(A) The obligation is registered as to both principal and any stated interest with the issuer (or its agent) and transfer of the obligation may be effected only by surrender of the old instrument, and either the reissuance by the issuer of the old instrument to the new holder or the issuance by the issuer of a new instrument to the new holder;

(B) The right to the principal of, and stated interest on, the obligation may be transferred only through a book entry system maintained by the issuer (or its agent) described in this paragraph (c)(1)(i)(B). An obligation shall be considered transferable through a book entry system if the ownership of an interest in the obligation, is required to be reflected in a book entry, whether or not physical securities are issued. A book entry is a record of ownership that identifies the owner of an interest in the obligation; or

(C) It is registered as to both principal and any stated interest with the issuer (or its agent) and may be transferred by way of either of the methods described in paragraph (c)(1)(i) (A) or (B) of this section.

(ii) *Requirements for portfolio interest qualification in the case of an obligation in registered form.* Interest (including original issue discount) received on an

obligation that is in registered form qualifies as portfolio interest only if—

(A) The interest is paid on an obligation issued after July 18, 1984;

(B) The interest would be subject to tax under section 871(a)(1)(A), 871(a)(1)(C), 881(a)(1) or 881(a)(3) but for section 871(h) or 881(c);

(C) A United States (U.S.) person otherwise required to deduct and withhold tax under chapter 3 of the Internal Revenue Code (Code) receives a statement that meets the requirements of section 871(h)(5) that the beneficial owner of the obligation is not a U.S. person; and

(D) An exception under section 871(h) or 881(c) does not apply.

(2) through (c)(2)(iv) [Reserved]. For further guidance, see §1.871–14T(c)(2) through (c)(2)(iv).

(v) The U.S. person receives a statement from a securities clearing organization, a bank, or another financial institution that holds customers' securities in the ordinary course of its trade or business. In such case the statement must be signed under penalties of perjury by an authorized representative of the financial institution and must state that the institution has received from the beneficial owner a withholding certificate described in §1.1441–1(e)(2)(i) (a Form W–8 or an acceptable substitute form as defined §1.1441–1(e)(4)(vi)) or that it has received from another financial institution a similar statement that it, or another financial institution acting on behalf of the beneficial owner, has received the Form W–8 from the beneficial owner. In the case of multiple financial institutions between the beneficial owner and the U.S. person, this statement must be given by each financial institution to the one above it in the chain. No particular form is required for the statement provided by the financial institutions. However, the statement must provide the name and address of the beneficial owner, and a copy of the Form W–8 provided by the beneficial owner must be attached. The statement is subject to the same rules described in §1.1441–1(e)(4) that apply to intermediary Forms W–8 described in §1.1441–1(e)(3)(iii). If the information on the Form W–8 changes, the beneficial owner must so notify the financial institution acting on its behalf within 30 days of such changes, and the financial institution must promptly so inform the U.S. person. This notice also must be given if the financial institution has actual knowledge that the information has changed but has not been so informed by the beneficial owner. In the case of multiple financial institutions between the beneficial owner and the U.S. person, this notice must be given by each financial institution to the institution above it in the chain.

(vi) The U.S. person complies with procedures that the U.S. competent authority may agree to with the competent authority of a country with which the United States has an income tax treaty in effect.

(3) [Reserved]. For further guidance, see §1.871–14T(c)(3).

(i) [Reserved]. For further guidance, see §1.871–14T(c)(3)(i).

(ii) *Example*. The following example illustrates the rules of this paragraph (c)(3) and their coordination with §1.1441–1(b)(7):

Example. A is a withholding agent who, on October 12, 2001, pays interest on a registered obligation to B, a foreign corporation. B is a calendar year taxpayer, engaged in the conduct of a trade or business in the United States, and is, therefore, required to file an annual income tax return on Form 1120F. The interest, however, is not effectively connected with B's U.S. trade or business. On the date of payment, B has not furnished, and A cannot associate the payment with documentation for B. However, A does not withhold under section 1442, even though, under §1.1441–1(b)(3)(iii)(A), A should presume that B is a foreign person, because A's communications with B are mailed to an address in a foreign country. Assuming that B files a return for its taxable year ending December 31, 2001, and that its statute of limitations period with regard to that year expires on June 15, 2005, the interest paid on October 12, 2001, may qualify as portfolio interest only if B provides appropriate documentation to A on or before June 15, 2005. If B does not provide the documentation on or before June 15, 2005, and does not pay the tax, A is liable for the tax under section 1463, even if B provides the documentation to A after June 15, 2005. Therefore, the provisions in §1.1441–1(b)(7), regarding late-received documentation would not help A avoid liability for tax under section 1463 even if the documentation is furnished within the statute of limitations period of A. This is because, in a case involving interest, the documentation received within the limitations period of the

beneficial owner serves as a condition for the interest to qualify as portfolio interest. When documentation is received after the expiration of the beneficial owner's limitations period, the interest can no longer qualify as portfolio interest. On the other hand, A could rely on documentation that it receives after the expiration of B's limitations period to establish B's right to a reduced rate of withholding under an applicable income tax treaty (since, in such a case, a claim of treaty benefits is not conditioned upon providing documentation prior to the expiration of the beneficial owner's limitations period).

(4) [Reserved] For further guidance, see § 1.871–14T(c)(4).

(d) *Application of repeal of 30-percent withholding to pass-through certificates*—(1) *In general*. Interest received on a pass-through certificate qualifies as portfolio interest under section 871(h)(2) or 881(c)(2) if the interest satisfies the conditions described in paragraph (b)(1), (c)(1), or (e) of this section without regard to whether any obligation held by the fund or trust to which the pass-through certificate relates is described in paragraph (b)(1), (c)(1)(ii), or (e) of this section. This paragraph (d)(1) applies only to payments made to the holder of the pass-through certificate from the trustee of the pass-through trust and does not apply to payments made to the trustee of the pass-through trust. For example, a mortgage pass-through certificate in bearer form must meet the requirements set forth in paragraph (b)(1) of this section, but the obligations held by the fund or trust to which the mortgage pass-through certificate relates need not meet the requirements set forth in paragraph (b)(1), (c)(1)(ii), or (e) of this section. However, for purposes of paragraphs (b)(1), (c)(1)(ii), and (e) of this section and section 127 of the Tax Reform Act of 1984, a pass-through certificate will be considered as issued after July 18, 1984, only to the extent that the obligations held by the fund or trust to which the pass-through certificate relates are issued after July 18, 1984.

(2) *Interest in REMICs*. Interest received on a regular or residual interest in a REMIC qualifies as portfolio interest under section 871(h)(2) or 881(c)(2) if the interest satisfies the conditions described in paragraph (b)(1), (c)(1)(ii), or (e) of this section. For purposes of paragraph (b)(1), (c)(1)(ii), or (e) of this section, interest on a regular interest in a REMIC is not considered interest on any mortgage obligations held by the REMIC. The foregoing rule, however, applies only to payments made to the holder of the regular interest from the REMIC and does not apply to payments made to the REMIC. For purposes of paragraph (b)(1), (c)(1)(ii), or (e) of this section, interest on a residual interest in a REMIC is considered to be interest on or with respect to the obligations held by the REMIC, and not on or with respect to the residual interest. For purposes of paragraphs (b)(1), (c)(1)(ii), and (e) of this section and section 127 of the Tax Reform Act of 1984, a residual interest in a REMIC will be considered as issued after July 18, 1984, only to the extent that the obligations held by the REMIC are issued after July 18, 1984, but a regular interest in a REMIC will be considered as issued after July 18, 1984, if the regular interest was issued after July 18, 1984, without regard to the date on which the mortgage obligations held by the REMIC were issued.

(3) *Date of issuance*. In general, a mortgage pass-through certificate will be considered to have been issued after July 18, 1984, if all of the mortgages held by the fund or trust were issued after July 18, 1984. If some of the mortgages held by the fund or trust were issued before July 19, 1984, then the portion of any interest payment which represents interest on those mortgages shall not be considered to be portfolio interest. The preceding sentence shall not apply, however, if all of the following conditions are satisfied:

(i) The mortgage pass-through certificate is issued after December 31, 1986;

(ii) Payment of the mortgage pass-through certificate is guaranteed by, and a guarantee commitment has been issued by, an entity that is independent from the issuer of the underlying obligation;

(iii) The guarantee commitment with respect to the mortgage pass-through certificate cannot have been issued more than 14 months prior to the date on which the mortgage pass-through certificate is issued; and

(iv) The fund or trust to which the mortgage pass-through certificate relates cannot contain mortgage obligations on which the first scheduled monthly payment of principal and interest was made more than twelve months before the date on which the guarantee commitment was made.

(e) *Foreign-targeted registered obligations*—(1) [Reserved] For further guidance, see § 1.871–14T(e)(1).

(2) *Definition of a foreign-targeted registered obligation.* An obligation is considered to be targeted to foreign markets for purposes of paragraph (e)(1) of this section if it is sold (or resold in connection with its original issuance) only to foreign persons (or to foreign branches of United States financial institutions described in section 871(h)(5)(B)) in accordance with procedures similar to those prescribed in § 1.163–5(c)(2)(i) (A), (B), or (D). However, the provisions of that section that require an obligation to be offered for sale or resale in connection with its original issuance only outside the United States do not apply with respect to registered obligations offered for sale through a public auction. Similarly, the provisions of that section that require delivery to be made outside the United States do not apply to registered obligations offered for sale through a public auction if the obligations are considered to be in registered form by virtue of the fact that they may be transferred only through a book entry system. The obligation, if evidenced by a physical document other than a confirmation receipt, must contain on its face a legend indicating that it has been sold (or resold in connection with its original issuance) in accordance with those procedures.

(3) *Documentation.* A certificate described in paragraph (e)(3)(i) of this section is required if the United States person otherwise required to deduct and withhold tax (the withholding agent) pays interest to a financial institution described in section 871(h)(5)(B) or to a member of a clearing organization, which member is the beneficial owner of the obligation. The documentation described in paragraph (e)(3)(ii) of this section is required if a withholding agent pays interest to a beneficial owner that is neither a financial institution described in section 871(h)(5)(B) nor a member of a clearing organization.

(i) *Interest paid to a financial institution or a member of a clearing organization*—(A) *Requirement of a certificate*—(*1*) If the withholding agent pays interest to a financial institution described in section 871(h)(5)(B) or to a member of a clearing organization, which member is the beneficial owner of the obligation, the withholding agent must receive a certificate which states that, beginning at the time the last preceding certificate under this paragraph (e)(3)(i) was provided and while the financial institution or clearing organization member has held the obligation, with respect to each foreign-targeted registered obligation which has been held by the person providing the certificate at any time since the provision of such last preceding certificate, either—

(*i*) The beneficial owner of the obligation has not been a United States person on each interest payment date; or

(*ii*) If the person providing the certificate is a financial institution which is holding or has held an obligation on behalf of the beneficial owner, the beneficial owner of the obligation has been a United States person on one or more interest payment dates (identifying such date or dates), and the person making the certification has forwarded or will forward the appropriate United States beneficial ownership notification to the withholding agent in accordance with the provisions of paragraph (e)(4) of this section.

(*2*) The person providing the certificate need not state the foregoing where no previous certificate has been required to be provided by the payee to the withholding agent under this paragraph (e)(3)(i).

(B) *Additional representations.* Whether or not a previous certificate has been required to be provided with respect to the obligation, each certificate furnished pursuant to the provisions in this paragraph (e)(3)(i) must further state that, for each foreign-targeted registered obligation held and every other such obligation to be acquired and held by the person providing the certificate during the period beginning

on the date of the certificate and ending on the date the next certificate is required to be provided, the beneficial owner of the obligation will not be a United States person on each interest payment date while the financial institution or clearing organization member holds the obligation and that, if the person providing the certificate is a financial institution which is holding or will be holding the obligation on behalf of a beneficial owner, such person will provide a United States beneficial ownership notification to the withholding agent (and a clearing organization that is not a withholding agent where a member organization is required by this paragraph (e)(3) to furnish the clearing organization with a statement) in accordance with paragraph (e)(4) of this section in the event such certificate (or statement in the case of a statement provided by a member organization to a clearing organization that is not a withholding agent) is or becomes untrue with respect to any obligation. A clearing organization is an entity which is in the business of holding obligations for member organizations and transferring obligations among such members by credit or debit to the account of a member without the necessity of physical delivery of the obligation.

(C) *Obligation must be identified.* The certificate described in paragraph (e)(3)(ii)(A) of this section must identify the obligation or obligations with respect to which it is given, except where the certification is given with respect to an obligation that has not been acquired at the time the certification is made. An obligation is identified if it or the larger issuance of which it is a part is described on a list (e.g., $5 million principal amount of 12% debentures of ABC Savings and Loan Association due February 25, 1995, $3 million principal amount of 10% U.S. Treasury notes due May 28, 1990) of all registered obligations targeted to foreign markets held by or on behalf of the person providing the certificate and the list is attached to, and incorporated by reference into, the certificate. The certificate must identify and provide the address of the person furnishing the certificate.

(D) *Payment to a depository of a clearing organization.* If the withholding agent pays interest to a depository of a clearing organization, then the clearing organization must provide the certificate described in this paragraph (e)(3)(i) to the withholding agent. Any certificate that is provided by a clearing organization must state that the clearing organization has received a statement from each member which complies with the provisions of this paragraph (e)(3)(i) and of paragraph (e)(4) of this section (as if the clearing organization were the withholding agent and regardless of whether the member is a financial institution described in section 871(h)(5)(B)).

(E) *Statement in lieu of Form W–8.* Subject to the requirements set out in paragraph (e)(4) of this section, a certificate or statement in the form described in this paragraph (e)(3)(i), in conjunction with the next annual certificate or statement, will serve as the certificate that may be provided in lieu of a Form W–8 with respect to interest on all foreign-targeted registered obligations held by the person making the certification or statement and which is paid to such person within the period beginning on the date of the certificate and ending on the date the next certificate is required to be provided.

(F) *Electronic transmission.* The certificate described in this paragraph (e)(3)(i) may be provided electronically under the terms and conditions of §1.163–5(c)(2)(i)(D)(*3*)(*ii*).

(ii) *Payment to a person other than a financial institution or member of a clearing organization.* If the withholding agent pays interest to the beneficial owner of an obligation that is neither a financial institution described in section 871(h)(5)(B) nor a member of a clearing organization, then such owner must provide the withholding agent a statement described in paragraph (c)(1)(ii)(C) of this section.

(4) *Applicable procedures regarding documentation*—(i) *Procedures applicable to certificates required under paragraph (e)(3)(i) of this section*—(A) *Time for providing certificate.* Where no previous certificate for foreign-targeted registered obligations has been provided to the withholding agent by the person

providing the certificate under paragraph (e)(3)(i) of this section, such certificate must be provided within the period beginning 90 days prior to the first interest payment date on which the person holds a foreign-targeted registered obligation. The withholding agent may, in its discretion, withhold under section 1441(a), 1442(a), or 1443 if the certificate is not received by the date 30 days prior to the interest payment. Thereafter the certificate must be filed within the period beginning on January 15 and ending January 31 of each year. If a certificate provided pursuant to the first sentence of this paragraph (e)(4)(i)(A) is provided during the period beginning on January 15 and ending on January 31 of any year, then no other certificate need be provided during such period in such year.

(B) *Change of status notification on Form W–9.* If, on any interest payment date after the obligation was acquired by the person making the certification, the beneficial owner of the obligation is a U.S. person, then the person to whom the withholding agent pays interest must furnish the withholding agent with a U.S. beneficial ownership notification within 30 days after such interest payment date. A U.S. beneficial ownership notification must include a statement that the beneficial owner of the obligation has been a U.S. person on an interest payment date (identifying such date), that such owner has provided to the person providing the notification a Form W–9 (or a substitute form that is substantially similar to Form W–9 and completed under penalties of perjury), and that the person providing the notification has been and will be complying with the information reporting requirements of section 6049, if applicable.

(C) *Alternative notification statement.* Where the person providing the notification described in paragraph (e)(4)(i)(B) of this section is neither a controlled foreign corporation within the meaning of section 957(a), nor a foreign corporation 50-percent or more of the gross income of which from all sources for the three-year period ending with the close of the taxable year preceding the date of the statement was effectively connected with the conduct of trade or business in the United States, such person must attach to the notification a copy of the Form W–9 (or substitute form that is substantially similar to Form W–9 and completed under penalties of perjury) provided by the beneficial owner. When a person that provides the U.S. beneficial ownership notification does not attach to it a copy of such Form W–9 (or substitute form that is substantially similar to Form W–9 and completed under penalties of perjury), such person must state that it is either a controlled foreign corporation within the meaning of section 957(a), or a foreign corporation 50-percent or more of the gross income of which from all sources for the three-year period ending with the close of its taxable year preceding the date of the statement was effectively connected with the conduct of a trade or business in the United States. A withholding agent that receives a Form W–9 (or a substitute form that is substantially similar to Form W–9 and completed under penalties of perjury) must send a copy of such form to the IRS, at such address as the IRS shall indicate, within 30 days after receiving it and must attach a statement that the Form W–9 or substitute form was provided pursuant to this paragraph (e)(4) with respect to a U.S. person that has owned a foreign-targeted registered obligation on one or more interest payment dates.

(D) *Failure to provide notification.* If either a Form W–9 (or a substitute form that is substantially similar to a Form W–9 and completed under penalties of perjury) or the statement described in paragraph (e)(4)(i)(C) of this section is not attached to the U.S. beneficial ownership notification provided pursuant to paragraph (e)(4)(i)(B) of this section, the withholding agent is required to withhold under section 1441, 1442, or 1443 on a payment of interest made after the withholding agent has received the notification unless such form or statement (or a statement that the beneficial owner of the obligation is no longer a U.S. person) is received before the interest payment date from the person who provided the notification (or transferee). If, during the period beginning on the next January 15 and ending on the next January 31, such person certifies as set out in

paragraph (e)(3)(i) of this section (subject to paragraph (e)(3)(i)(A)(*2*) of this section) then the withholding agent is not required to withhold during the year following such certification (unless such person again provides a U.S. beneficial ownership notification without attaching a Form W–9 or substitute form that is substantially similar to Form W–9 and completed under penalties of perjury or the statement described in paragraph (e)(4)(i)(C) of this section).

(E) *Procedures for clearing organizations.* Within the period beginning 10 days before the end of the calendar quarter and ending on the last day of each calendar quarter, any clearing organization (including a clearing organization that is a withholding agent) relying on annual certificates or statements from its member organizations, as set forth in paragraph (e)(3)(i) of this section, must send each member organization having submitted such certificate or statement a reminder that the member organization must give the clearing organization a U.S. beneficial ownership notification in the circumstances described in paragraph (e)(4)(i)(B) of this section.

(F) *Retention of certificates.* The certificate described in paragraph (e)(3)(i) of this section must be retained in the records of the withholding agent for four years from the end of the calendar year in which it was received. The statement described in paragraph (e)(3)(i) of this section that is received by a clearing organization from a member organization must be retained in the records of the clearing organization for four years from the end of the calendar year in which it was received.

(G) *No reporting requirement.* The withholding agent who receives the certificate described in paragraph (e)(3)(i) of this section is not required to file Form 1042S to report payments under §1.1461–1 (b) or (c) of interest that are made with respect to foreign-targeted registered obligations held by the person providing the certificate and are made within the period beginning with the certificate date and ending on the last date for filing the next certificate.

(ii) *Procedures regarding certificates required under paragraph (e)(3)(ii) of this section*—(A) *Time for providing certificate.* The statement described in paragraph (e)(3)(ii) of this section must be provided to the withholding agent within the period beginning 90 days prior to and ending on the first interest payment date on which the withholding agent pays interest to the beneficial owner. The withholding agent may, in its discretion, withhold under section 1441(a), 1442(a), or 1443 if the statement is not received by the date 30 days prior to the interest payment. The beneficial owner must confirm to the withholding agent the continuing validity of the documentary evidence within the period beginning 90 days prior to the first day of the third calendar year following the provision of such evidence and during the same period every three years thereafter while the owner still owns the obligation. The withholding agent who receives the statement described in paragraph (e)(3)(ii) of this section is not required to report payments of interest under §1.1461–1(b) or (c) if the payments are made with respect to foreign-targeted registered obligations held by the person who provides the statement and are made within the period beginning with the date on which the statement is provided and ending on the last date for confirming the validity of the statement. The statement received for purposes of paragraph (e)(3)(ii) of this section is subject to the applicable procedures set forth in §1.1441–1(e)(4).

(B) *Change of status notification on Form W–9.* If on any interest payment date after the obligation was acquired by the person providing the statement described in paragraph (e)(3)(ii) of this section, the beneficial owner of the obligation is a U.S. person, then the beneficial owner must so inform the withholding agent within 30 days after such interest payment date and must provide a Form W–9 (or substitute form that is substantially similar completed under penalties of perjury) to the withholding agent. However, the beneficial owner is not required to provide another Form W–9 (or substitute form that is substantially similar and completed under penalties of perjury) if such person has already provided it to the withholding agent within the same calendar year.

(iii) *Disqualification of documentation.* In accordance with the provisions of section 871(h)(4), the Secretary may make a determination in appropriate cases that a certificate or statement by any person, or class of persons, does not satisfy the requirements of that section. Should that determination be made, all payments of interest that otherwise qualify as portfolio interest to that person would become subject to 30-percent withholding under section 1441(a), 1442(a), or 1443.

(iv) *Special effective date.* Notwithstanding the foregoing requirements of this section—

(A) Any certificate that is required to be filed with the withholding agent during the period beginning on January 15 and ending on January 31, 1986, is not required to state that the beneficial owner of an obligation, prior to the date of the certificate, either was not a United States person or was a United States person if the obligation was acquired by the person providing the certificate on or before September 19, 1985; and

(B) All of the requirements of this paragraph (e), as in effect prior to the effective date of these amendments, shall remain effective with respect to each interest payment prior to the filing of the certificate described in paragraph (e)(4)(iv)(A) of this section, except that the provisions of paragraph (e)(3) of this section relating to which persons are required to receive certificates or statements and paragraph (e)(3)(ii) or (4)(ii) of this section shall become effective with respect to each interest payment after September 20, 1985.

(5) *Information reporting.* See §1.6049–5(b)(7) for special information reporting rules applicable to interest on foreign-targeted registered obligations. See §1.6045–1(g)(1)(ii) for information reporting rules applicable to the redemption, retirement, or sale of foreign-targeted registered obligations.

(f) *Securities lending transactions.* For applicable rules regarding substitute interest payments received pursuant to a securities lending transaction or a sale-repurchase transaction, see §§1.871–7(b)(2) and 1.881–2(b)(2).

(g) *Portfolio interest not to include interest received by 10-percent shareholders*—(1) *In general.* For purposes of section 871(h), the term *portfolio interest* shall not include any interest received by a 10-percent shareholder.

(2) *Ten-percent shareholder*—(i) *In general.* The term *10-percent shareholder* means—

(A) In the case of an obligation issued by a corporation, any person who owns 10-percent or more of the total combined voting power of all classes of stock of such corporation entitled to vote; or

(B) In the case of an obligation issued by a partnership, any person who owns 10-percent or more of the capital or profits interest in such partnership.

(ii) *Ownership*—(A) *Stock ownership.* For purposes of paragraph (g)(2)(i)(A) of this section, *stock owned* means stock directly or indirectly owned and stock owned by reason of the attribution rules of section 318(a), as modified by section 871(h)(3)(C).

(B) *Ownership of partnership interest.* For purposes of paragraph (g)(2)(i)(B) of this section, rules similar to the rules in paragraph (g)(2)(ii)(A) of this section shall be applied in determining the ownership of a capital or profits interest in a partnership.

(3) *Application of 10-percent shareholder test to partners receiving interest through a partnership*—(i) *Partner level test.* Whether interest paid to a partnership and included in the distributive share of a partner that is a nonresident alien individual or foreign corporation is received by a 10 percent shareholder shall be determined by applying the rules of this paragraph (g) only at the partner level.

(ii) *Time at which 10-percent shareholder test is applied.* The determination of whether a nonresident alien individual or foreign corporation that is a partner in a partnership is a 10-percent shareholder under the rules of section 871(h)(3), section 881(c)(3), and this paragraph (g) with respect to interest paid to such partnership shall be made at the time that the withholding agent, absent the provisions of section 871(h), 881(c) and the rules of this paragraph, would otherwise be required to withhold under sections 1441 and 1442 with respect to such interest. For example, in the case of U.S. source interest paid

by a domestic corporation to a domestic partnership or withholding foreign partnership (as defined in §1.1441–5(c)(2)), the 10-percent shareholder test is applied when any distributions that include the interest are made to a foreign partner and, to the extent that a foreign partner's distributive share of the interest has not actually been distributed, on the earlier of the date that the statement required under section 6031(b) is mailed or otherwise provided to such partner, or the due date for furnishing such statement. See §1.1441–5(b)(2) and (c)(2)(iii).

(4) *Application of 10-percent shareholder test to interest paid to a simple trust or grantor trust.* Whether interest paid to a simple trust or grantor trust and distributed to or included in the gross income of a nonresident alien individual or foreign corporation that is a beneficiary or owner of such trust, as the case may be, is received by a 10-percent shareholder shall be determined by applying the rules of this paragraph (g) only at the beneficiary or owner level. The 10-percent shareholder test is applied with respect to a nonresident alien individual or foreign corporation that is a beneficiary of a simple trust or an owner of a grantor trust at the time that a withholding agent, absent any exceptions, would otherwise be required to withhold under sections 1441 and 1442 with respect to such interest.

(h) *Portfolio interest not to include certain contingent interest*—(1) *Dividend equivalents.* Contingent interest does not qualify as portfolio interest to the extent that the interest is a dividend equivalent within the meaning of section 871(m).

(2) *Amount of dividend equivalent that is not portfolio interest.* The amount that does not qualify as portfolio interest because it is a dividend equivalent equals the amount of the dividend equivalent determined pursuant to §1.871–15(j). Unless otherwise excluded pursuant to section 871(h), any other interest paid on an obligation that is not a dividend equivalent may qualify as portfolio interest.

(i) *Definitions.* For purposes of this section, the terms *U.S. person* and *foreign person* have the meaning set forth in §1.1441–1(c)(2), the term *beneficial owner* has the meaning set forth in §1.1441–1(c)(6), the term *withholding agent* has the meaning set forth in §1.1441–7(a); the term *payee* has the meaning set forth in §1.1441–1(b)(2); and the term *payment* has the meaning set forth in §1.1441–2(e).

(j) *Effective date*—(1) *In general.* This section shall apply to payments of interest made after December 31, 2000. The rules of paragraph (g) apply to interest paid after April 12, 2007. Taxpayers may choose to apply the rules of paragraph (g) to interest paid in any taxable year not closed by the period of limitations as of April 12, 2007, provided they do so consistently for all relevant partnerships during such years.

(2) *Transition rule.* For purposes of this section, the validity of a Form W–8 that was valid on January 1, 1998, under the regulations in effect prior to January 1, 2001 (see 26 CFR parts 1 and 35a, revised April 1, 1999) and expired, or will expire, at any time during 1998, is extended until December 31, 1998. The validity of a Form W–8 that is valid on or after January 1, 1999 remains valid until its validity expires under the regulations in effect prior to January 1, 2001 (see 26 CFR parts 1 and 35a, revised April 1, 1999) but in no event will such a form remain valid after December 31, 2000. The rule in this paragraph (h)(2), however, does not apply to extend the validity period of a Form W–8 that expired solely by reason of changes in the circumstances of the person whose name is on the certificate. Notwithstanding the first three sentences of this paragraph (h)(2), a withholding agent or payor may choose to not take advantage of the transition rule in this paragraph (h)(2) with respect to one or more withholding certificates valid under the regulations in effect prior to January 1, 2001 (see 26 CFR parts 1 and 35a, revised April 1, 1999) and, therefore, may choose to obtain withholding certificates conforming to the requirements described in this section (new withholding certificates). For purposes of this section, a new withholding certificate is deemed to satisfy the documentation requirement under the regulations in effect prior to January 1, 2001 (see 26 CFR parts 1 and 35a, revised April 1,

1999). Further, a new withholding certificate remains valid for the period specified in §1.1441–1(e)(4)(ii), regardless of when the certificate is obtained.

(3) *Effective/applicability date.* The rules of paragraph (h) of this section apply beginning September 18, 2015.

[T.D. 8734, 62 FR 53416, Oct. 14, 1997, as amended by T.D. 8804, 63 FR 72184, 72187, Dec. 31, 1998; T.D. 8856, 64 FR 73409, 73412, Dec. 30, 1999; T.D. 9323, 72 FR 18387, Apr. 12, 2007; 72 FR 26543, May 10, 2007. T.D. 9658, 79 FR 12746, Mar. 6, 2013; 79 FR 37182, July 1, 2014; T.D. 9734, 80 FR 56879, Sept. 18, 2015]

§1.871–14T Rules relating to repeal of tax on interest of nonresident alien individuals and foreign corporations received from certain portfolio debt investments (temporary).

(a) [Reserved] For further guidance, see §1.871–14(a).

(b) *Rules concerning obligations in bearer form before March 19, 2012*—(1) *In general.* Interest (including original issue discount) with respect to an obligation in bearer form is portfolio interest within the meaning of section 871(h)(2)(A) or 881(c)(2)(A) only if it is paid with respect to an obligation issued after July 18, 1984, and issued before March 19, 2012, that is described in section 163(f)(2)(B), as in effect prior to the amendment by section 502 of the Hiring Incentives to Restore Employment Act of 2010 (HIRE Act), Public Law 111–147, and the regulations under that section and an exception under section 871(h) or 881(c) does not apply. Any obligation that is not in registered form as defined in paragraph (c)(1)(i) of this section is an obligation in bearer form.

(2) *Coordination with withholding and reporting rules.* For an exemption from withholding under section 1441 with respect to obligations described in this paragraph (b), see §1.1441–1(b)(4)(i). See §1.1471–2 for rules relating to withholding under chapter 4 of the Code that may apply to withholdable payments (as defined in §1.1471–4(b)(145)) made on or after July 1, 2014, with respect to an agreement or instrument that is not treated as an obligation outstanding before March 19, 2012. For purposes of the preceding sentence, the terms *obligation* and *outstanding* are described in §1.1471–2(b)). See also §1.1471–4(d)(6) for the reporting requirements of participating foreign financial institutions (as defined in §1.1471–1(b)(91)) with respect to accounts held by recalcitrant account holders (as defined in §1.1471–5(g)). For rules relating to an exemption from Form 1099 reporting and backup withholding under section 3406, see section 6049 and §1.6049–5(b)(8) for the payment of interest and §1.6045–1(g)(1)(ii) for the redemption, retirement, or sale of an obligation in bearer form.

(c)(1) through (c)(1)(ii)(D) [Reserved] For further guidance, see §1.1871–14(c)(1) introductory text through (c)(1)(ii)(D).

(2) *Required statement.* For purposes of paragraph (c)(1)(ii)(C) of this section, a U.S. person will be considered to have received a statement that meets the requirements of section 871(h)(5) if either it complies with one of the procedures described in this paragraph (c)(2) and does not have actual knowledge or reason to know that the beneficial owner is a U.S. person or it complies with the procedures described in paragraph (d) or (e) of this section (to the extent applicable).

(i) The U.S. person (or its authorized agent described in §1.1441–7(c)(2)) can reliably associate the payment with documentation upon which it can rely to treat the payment as made to a foreign beneficial owner in accordance with §1.1441–1(e)(1)(ii). See §1.1441–1(b)(2)(vii) for rules regarding reliable association with documentation.

(ii) The U.S. person (or its authorized agent described in §1.1441–7(c)(2)) can reliably associate the payment with a withholding certificate described in §1.1441–5(c)(2)(iv) from a person claiming to be a withholding foreign partnership or §1.1441–5(e)(v) for a person claiming to be a withholding foreign trust.

(iii) The U.S. person (or its authorized agent described in §1.1441–7(c)(2)) can reliably associate the payment with a withholding certificate described in §1.1441–1(e)(3)(ii) from a person representing to be a qualified intermediary that has assumed primary withholding responsibility for the payment in accordance with §1.1441–1(e)(5)(iv) or a qualified intermediary that has provided a withholding statement that meets the requirements of

§ 1.1441–1(e)(5)(v)(C) or that includes the payment in a withholding rate pool for payments excepted from withholding.

(iv) The U.S. person (or its authorized agent described in § 1.1441–7(c)(2)) can reliably associate the payment with a withholding certificate described in § 1.1441–1(e)(3)(v) from a person claiming to be a U.S. branch of a foreign bank or of a foreign insurance company that is described in § 1.1441–1(b)(2)(iv)(A) or a U.S. branch designated in accordance with § 1.1441–1(b)(2)(iv)(E).

(v) and (vi) [Reserved]. For further guidance, see § 1.871–14(c)(2)(v) and (vi).

(3) *Time for providing certificate or documentary evidence*—(i) *General rule*. Interest on a registered obligation shall qualify as portfolio interest if the withholding certificate or documentary evidence that must be provided is furnished before expiration of the beneficial owner's period of limitation for claiming a refund of tax with respect to such interest. See, however, § 1.1441–1(b)(7) for consequences to a withholding agent that makes a payment without withholding even though it cannot reliably associate the payment with the documentation prior to the payment. If a withholding agent withholds an amount under chapter 3 of the Code because it cannot reliably associate the payment with the documentation for the beneficial owner on the date of payment, the beneficial owner may nevertheless claim the benefit of an exemption from tax under this section by claiming a refund or credit for the amount withheld based upon the procedures described in §§ 1.1464–1 and 301.6402–3(e) of this chapter. See § 1.1474–5 and § 301.6402–3(e) for the allowance and requirements for a refund with respect to an amount (including a payment of interest) that was withheld upon under chapter 4 of the Code. In the alternative, adjustments to any amount of overwithheld tax may be made under the procedures described in § 1.1461–2(a) for a payment withheld upon under chapter 3 of the Code or in § 1.1474–2 for a payment withheld upon under chapter 4 of the Code.

(ii) [Reserved] For further guidance, see § 1.871–14(c)(3)(ii).

(4) *Coordination with withholding and reporting rules*. For an exemption from withholding under section 1441 with respect to obligations described in this paragraph (c)(4), see § 1.1441–1(b)(4)(i). For rules applicable to withholding certificates, see § 1.1441–1(e)(4). For rules regarding documentary evidence, see § 1.6049–5(c)(1). For application of presumptions when the U.S. person cannot reliably associate the payment with documentation, see § 1.1441–1(b)(3). For standards of knowledge applicable to withholding agents, see § 1.1441–7(b). For rules relating to reporting on Forms 1042 and 1042–S, see § 1.1461–1(b) and (c). For rules relating to an exemption from Form 1099 reporting and backup withholding under section 3406, see section 6049 and § 1.6049–5(b)(8) for the payment of interest and § 1.6045–1(g)(1)(i) for the redemption, retirement, or sale of an obligation in registered form. For rules relating to withholding under sections 1471 and 1472 that may apply notwithstanding the exemption for payments of portfolio interest under section 1441, see §§ 1.1471–2(a), 1.1471–4(b), and 1.1472–1(b).

(d) [Reserved] For further guidance, see § 1.871–14(d) introductory text through (d)(3)(iv).

(e) *Foreign-targeted registered obligations*—(1) *General rule*. The statement described in paragraph (c)(1)(ii) of this section is not required with respect to interest paid on an obligation issued before January 1, 2016, that is a registered obligation targeting foreign markets in accordance with the provisions of paragraph (e)(2) of this section if the interest is paid by a U.S. person, a withholding foreign partnership, or a U.S. branch described in § 1.1441–1(b)(2)(iv)(A) or (E) to a registered owner at an address outside the United States, provided that the registered owner is a financial institution described in section 871(h)(5)(B). In that case, the U.S. person otherwise required to deduct and withhold tax may treat the interest as portfolio interest if it does not have actual knowledge that the beneficial owner is a United States person and if it receives the certificate described in paragraph (e)(3)(i) of this section from a financial institution or member of a clearing organization, which member is the beneficial

owner of the obligation, or the documentary evidence or statement described in paragraph (e)(3)(ii) of this section from the beneficial owner, in accordance with the procedures described in paragraph (e)(4) of this section.

(2) through (i)(2) [Reserved] For further guidance, see §1.871–14(e)(2) through (i)(2).

(3) *Effective/applicability date*. The rules of paragraphs (b)(2), (c)(3)(i), and (c)(4) of this section apply to payments of interest made after June 30, 2014. (For payments of interest made before July 1, 2014, see paragraphs (b)(2), (c)(3)(i), and (c)(4) of this section as in effect prior to February 28, 2017.)

(j) *Expiration date*. The applicability of this section expires on or before February 28, 2017.

[T.D. 9658, 79 FR 12746, Mar. 6, 2014, as amended by T.D. 9658, 79 FR 37182, July 1, 2014]

§ 1.871–15 Treatment of dividend equivalents.

(a) *Definitions*. For purposes of this section, the following terms have the meanings described in this paragraph (a).

(1) *Broker*. A *broker* is a broker within the meaning provided in section 6045(c).

(2) *Dealer*. A *dealer* is a dealer in securities within the meaning of section 475(c)(1).

(3) *Dividend*. A *dividend* is a dividend as described in section 316.

(4) *Equity-linked instrument*. An *equity-linked instrument* (*ELI*) is a financial transaction, other than a securities lending or sale-repurchase transaction or an NPC, that references the value of one or more underlying securities. For example, a futures contract, forward contract, option, debt instrument, or other contractual arrangement that references the value of one or more underlying securities is an ELI.

(5) *Initial hedge*. An *initial hedge* is the number of underlying security shares that a short party would need to fully hedge an NPC or ELI (whether the NPC or ELI is a complex contract or a simple contract benchmark (within the meaning of paragraph (h)(2) of this section), as appropriate) with respect to an underlying security at the time the NPC or ELI is issued, even if the short party does not in fact fully hedge the NPC or ELI.

(6) *Issue*. An NPC or ELI is treated as issued at inception, original issuance, or at the time of an issuance as a result of a deemed exchange pursuant to section 1001.

(7) *Notional principal contract*. A *notional principal contract* (*NPC*) is a notional principal contract as defined in §1.446–3(c).

(8) *Option*. An *option* includes an option embedded in any debt instrument, forward contract, NPC, or other potential section 871(m) transaction.

(9) *Parties to the transaction*—(i) *Long party*. A *long party* is the party to a potential section 871(m) transaction with respect to an underlying security that would be entitled to receive a payment of a dividend equivalent (within the meaning of paragraph (i) of this section) described in paragraph (c) of this section.

(ii) *Short party*. A *short party* is the party to a potential section 871(m) transaction with respect to an underlying security that would be obligated to make a payment of a dividend equivalent (within the meaning of paragraph (i) of this section) described in paragraph (c) of this section.

(iii) *Party to the transaction*. A *party to the transaction* is any person that is a long party or a short party to a potential section 871(m) transaction, any agent acting on behalf of the long party or short party, or any person acting as an intermediary with respect to the potential section 871(m) transaction.

(iv) *Party to the transaction that is both a long party and a short party*—(A) *In general*. If a potential section 871(m) transaction references more than one underlying security, the long party and short party are determined separately with respect to each underlying security. A party to a potential section 871(m) transaction is both a long party and a short party when the party is entitled to a payment that references a dividend payment on an underlying security and the same party is obligated to make a payment that references a dividend payment on another underlying security pursuant to the potential section 871(m) transaction.

(B) *Example*. The following example illustrates the definitions in paragraph (a)(9) of this section:

Example. (i) Stock X and Stock Y are underlying securities. A and B enter into an NPC that entitles A to receive payments from B based on any appreciation in the value of Stock X and dividends paid on Stock X during the term of the contract and obligates A to make payments to B based on any depreciation in the value of Stock X during the term of the contract. In return, the NPC entitles B to receive payments from A based on any appreciation in the value of Stock Y and dividends paid on Stock Y during the term of the contract and obligates B to make payments to A based on any depreciation in the value of Stock Y during the term of the contract.

(ii) A is the long party with respect to Stock X, and the short party with respect to Stock Y. B is the long party with respect to Stock Y, and the short party with respect to Stock X.

(10) *Payment*. A *payment* has the meaning provided in paragraph (i) of this section.

(11) *Reference*. To *reference* means to be contingent upon or determined by reference to, directly or indirectly, whether in whole or in part.

(12) *Section 871(m) transaction and potential section 871(m) transaction*. A *section 871(m) transaction* is any securities lending or sale-repurchase transaction, specified NPC, or specified ELI. A *potential section 871(m) transaction* is any securities lending or sale-repurchase transaction, NPC, or ELI that references one or more underlying securities.

(13) *Securities lending or sale-repurchase transaction*. A *securities lending or sale-repurchase transaction* is any securities lending transaction, sale-repurchase transaction, or substantially similar transaction that references an underlying security. *Securities lending transaction* and *sale-repurchase transaction* have the same meaning as provided in § 1.861–3(a)(6).

(14) *Simple contracts and complex contracts*—(i) *Simple contract*. A *simple contract* is an NPC or ELI for which, with respect to each underlying security,

(A) All amounts to be paid or received on maturity, exercise, or any other payment determination date are calculated by reference to a single, fixed number of shares (as determined in paragraph (j)(3) of this section) of the underlying security, provided that the number of shares can be ascertained when the contract is issued, and (B) The contract has a single maturity or exercise date with respect to which all amounts (other than any upfront payment or any periodic payments) are required to be calculated with respect to the underlying security. A contract has a single exercise date even though it may be exercised by the holder at any time on or before the stated expiration of the contract. An NPC or ELI that includes a term that discontinuously increases or decreases the amount paid or received (such as a digital option), or that accelerates or extends the maturity is not a simple contract. A simple contract that is an NPC is a *simple NPC*. A simple contract that is an ELI is a *simple ELI*.

(ii) *Complex contract*—(A) *In general*. A *complex contract* is any NPC or ELI that is not a simple contract. A complex contract that is an NPC is a *complex NPC*. A complex contract that is an ELI is a *complex ELI*.

(B) *Example*. An ELI entitles the long party to a return equal to 200 percent of the appreciation on 100 shares of Stock X, and obligates the long party to pay an amount equal to the actual depreciation on 100 shares of Stock X. Because the ELI does not provide the long party with an amount that is calculated by reference to a single, fixed number of shares of Stock X on the maturity date that can be ascertained at issuance, it is not a simple ELI. More specifically, upon maturity the ELI will either entitle the long party to receive a payment that is, in substance, measured by reference to 200 shares of stock or obligate the long party to make a payment measured by reference to 100 shares of stock. The ELI is a complex ELI because it is not a simple ELI.

(15) *Underlying security*. An *underlying security* is any interest in an entity if a payment with respect to that interest could give rise to a U.S. source dividend pursuant to § 1.861–3, where applicable taking into account paragraph (m) of this section. Except as provided in paragraph (l) of this section, if a potential section 871(m) transaction references an interest in more than one

entity described in the preceding sentence or different interests in the same entity, each referenced interest is a separate underlying security for purposes of applying the rules of this section.

(b) *Source of a dividend equivalent.* A dividend equivalent is treated as a dividend from sources within the United States for purposes of sections 871(a), 881, 892, 894, and 4948(a), and chapters 3 and 4 of subtitle A of the Internal Revenue Code.

(c) *Dividend equivalent*—(1) *In general.* Except as provided in paragraph (2), *dividend equivalent* means—

(i) Any payment that references the payment of a dividend from an underlying security pursuant to a securities lending or sale-repurchase transaction;

(ii) Any payment that references the payment of a dividend from an underlying security pursuant to a specified NPC described in paragraph (d) of this section;

(iii) Any payment that references the payment of a dividend from an underlying security pursuant to a specified ELI described in paragraph (e) of this section; and

(iv) Any other substantially similar payment as described in paragraph (f) of this section.

(2) *Exceptions*—(i) *Not a dividend.* A payment that references a distribution with respect to an underlying security is not a dividend equivalent to the extent that the distribution would not be subject to tax pursuant to section 871 or section 881 if the long party owned the underlying security. For example, if an NPC references stock in a regulated investment company that pays a dividend that includes a capital gains dividend described in section 852(b)(3)(C) that would not be subject to tax under section 871 or section 881 if paid directly to the long party, then an NPC payment is not a dividend equivalent to the extent that it is determined by reference to the capital gains dividend.

(ii) *Section 305 coordination.* A dividend equivalent with respect to a section 871(m) transaction is reduced by any amount treated in accordance with section 305(b) and (c) as a dividend with respect to the underlying security referenced by the section 871(m) transaction.

(iii) *Due bills.* A dividend equivalent does not include a payment made pursuant to a due bill arising from the actions of a securities exchange that apply to all transactions in the stock with respect to the dividend. For purposes of this section, a stock will be considered to trade with a due bill only when the relevant securities exchange has set an ex-dividend date with respect to a dividend that occurs after the record date.

(iv) *Certain payments pursuant to annuity, endowment, and life insurance contracts.* [Reserved]. For further guidance, see § 1.871–15T(c)(2)(iv).

(v) *Certain payments pursuant to employee compensation arrangements.* A dividend equivalent does not include the portion of equity-based compensation for personal services of a nonresident alien individual that is—

(A) Wages subject to withholding under section 3402 and the regulations under that section;

(B) Excluded from the definition of wages under § 31.3401(a)(6)–1; or

(C) Exempt from withholding under § 1.1441–4(b).

(d) *Specified NPCs*—(1) *Specified NPCs entered into before January 1, 2017*—(i) *In general.* For payments made after March 18, 2012, and before January 1, 2017, a specified NPC is any NPC if—

(A) In connection with entering into the contract, any long party to the contract transfers the underlying security to any short party to the contract;

(B) In connection with the termination of the contract, any short party to the contract transfers the underlying security to any long party to the contract;

(C) The underlying security is not readily tradable on an established securities market; or

(D) In connection with entering into the contract, the underlying security is posted as collateral by any short party to the contract with any long party to the contract.

(ii) *Specified NPC status as of January 1, 2017.* An NPC that is treated as a specified NPC pursuant to paragraph (d)(1)(i) of this section will remain a specified NPC on or after January 1, 2017.

(2) *Specified NPCs on or after January 1, 2017*—(i) *Simple NPCs*. A simple NPC that has a delta of 0.8 or greater with respect to an underlying security when the NPC is issued is a specified NPC.

(ii) *Complex NPCs*. A complex NPC that meets the substantial equivalence test described in paragraph (h) of this section with respect to an underlying security when the NPC is issued is a specified NPC.

(e) *Specified ELIs*—(1) *Simple ELIs*. A simple ELI that has a delta of 0.8 or greater with respect to an underlying security when the ELI is issued is a specified ELI.

(2) *Complex ELIs*. A complex ELI that meets the substantial equivalence test described in paragraph (h) of this section with respect to an underlying security when the ELI is issued is a specified ELI.

(f) *Other substantially similar payments*. For purposes of this section, any payment made in satisfaction of a tax liability of the long party with respect to a dividend equivalent by a withholding agent is a dividend equivalent received by the long party. The amount of that dividend equivalent constitutes additional income to the payee to the extent provided in § 1.1441–3(f)(1).

(g) *Delta*—(1) *In general*. Delta is the ratio of the change in the fair market value of an NPC or ELI to a small change in the fair market value of the number of shares of the underlying security (as determined under paragraph (j)(3) of this section) referenced by the NPC or ELI. If an NPC or ELI contains more than one reference to a single underlying security, all references to that underlying security are taken into account in determining the delta with respect to that underlying security. If an NPC or ELI references more than one underlying security or other property, the delta with respect to each underlying security must be determined without taking into account any other underlying security or property. The delta of an equity derivative that is embedded in a debt instrument or other derivative is determined without taking into account changes in the market value of the debt instrument or other derivative that are not directly related to the equity element of the instrument. Thus, for example, the delta of an option embedded in a convertible note is determined without regard to the debt component of the convertible note. For purposes of this section, delta must be determined in a commercially reasonable manner. If a taxpayer calculates delta for non-tax business purposes, that delta ordinarily is the delta used for purposes of this section.

(2) *Time for determining delta*. For purposes of applying the rules of this section, the delta of a potential section 871(m) transaction is determined only when the potential section 871(m) transaction is issued (as defined in paragraph (a)(6) of this section).

(3) *Simplified delta calculation for certain simple contracts that reference multiple underlying securities*. If an NPC or ELI references 10 or more underlying securities and the short party uses an exchange-traded security (for example, an exchange-traded fund) that references substantially all of the underlying securities (the hedge security) to hedge the NPC or ELI at the time it is issued, the delta of the NPC or ELI may be calculated by determining the ratio of the change in the fair market value of the simple contract to a small change in the fair market value of the hedge security. A delta determined under this paragraph (g)(3) must be used as the delta for each underlying security for purposes of calculating the amount of a dividend equivalent as provided in paragraph (j)(1)(ii) of this section.

(4) *Examples*. The following examples illustrate the rules of this paragraph (g). For purposes of these examples, Stock X and Stock Y are common stock of domestic corporations X and Y. LP is the long party to the transaction.

Example 1. Delta calculation for an NPC. The terms of an NPC require LP to pay the short party an amount equal to all of the depreciation in the value of 100 shares of Stock X and an interest-rate based return. In return, the NPC requires the short party to pay LP an amount equal to all of the appreciation in the value of 100 shares of Stock X and any dividends paid by X on those shares. The value of the NPC will change by $1 for each $0.01 change in the price of a share of Stock X. When LP entered into the NPC, Stock X had a fair market value of $50 per share. The NPC therefore has a delta of 1.0 ($1.00/($0.01 × 100)).

Example 2. Delta calculation for an option. LP purchases a call option that references 100 shares of Stock Y. At the time LP purchases the call option, the value of the option is expected to change by $0.30 for a $0.01 change in the price of a share of Stock Y. When LP purchases the option, Stock Y has a fair market value of $100 per share. The call option has a delta of 0.3 ($0.30/($0.01 × 100)).

(h) *Substantial Equivalence.* [Reserved]. For further guidance, see § 1.871–15T(h).

(i) *Payment of a dividend equivalent*—(1) *Payments determined on gross basis.* For purposes of this section, a payment includes any gross amount that references the payment of a dividend and that is used in computing any net amount transferred to or from the long party even if the long party makes a net payment to the short party or no amount is paid because the net amount is zero.

(2) *Actual and estimated dividends*—(i) *In general.* A payment includes any amount that references an actual or estimated payment of dividends, whether the reference is explicit or implicit. If a potential section 871(m) transaction provides for a payment based on an estimated dividend that adjusts to account for the amount of an actual dividend paid, the payment is treated as referencing the actual dividend amount and not an estimated dividend amount.

(ii) *Implicit dividends.* A payment includes an actual or estimated dividend payment that is implicitly taken into account in computing one or more of the terms of a potential section 871(m) transaction, including interest rate, notional amount, purchase price, premium, upfront payment, strike price, or any other amount paid or received pursuant to the potential section 871(m) transaction.

(iii) *Actual dividend presumption.* A short party to a section 871(m) transaction is treated as paying a per-share dividend amount equal to the actual dividend amount unless the short party to the section 871(m) transaction identifies a reasonable estimated dividend amount in writing at the time the transaction is issued. For this purpose, a reasonable estimated dividend amount stated in an offering document or the documents governing the terms at the time the transaction is issued will establish the estimated dividend amount. To qualify as an estimated dividend amount, the written estimated dividend amount must separately state the amount estimated for each anticipated dividend or state a formula that allows each dividend to be determined. If an underlying security is not expected to pay a dividend, a reasonable estimate of the dividend amount may be zero.

(iv) *Additions to estimated payments.* If a section 871(m) transaction provides for any payment in addition to an estimated dividend and that additional payment is determined by reference to a dividend (for example, a special dividend), both the estimated dividend and the additional payment are used to determine the per-share dividend amount.

(3) *Dividends for certain baskets*—(i) *In general.* If a section 871(m) transaction references long positions in more than 25 underlying securities, the short party may treat the dividends with respect to the referenced underlying securities as paid at the end of the applicable calendar quarter to compute the per-share dividend amount.

(ii) *Publicly available dividend yield.* For purposes of paragraph (i)(3)(i) of this section, if a section 871(m) transaction references the same underlying securities as a security (for example, stock in an exchange-traded fund) or index for which there is a publicly available quarterly dividend yield, the publicly available dividend yield may be used to determine the per-share dividend amount for the section 871(m) transaction with any adjustment for special dividends.

(iii) *Dividend yield for a section 871(m) transaction using the simplified delta calculation.* When the delta of a section 871(m) transaction is determined under paragraph (g)(3) of this section, the per-share dividend amount for that section 871(m) transaction must be determined using the dividend yield for the exchange-traded security that fully hedges the section 871(m) transaction.

(4) *Examples.* The following examples illustrate the rules of this paragraph (i). For purposes of these examples, Stock X is common stock of Corporation X, a domestic corporation, that historically pays quarterly dividends

on Stock X. The parties anticipate that Corporation X will continue to pay quarterly dividends.

Example 1. Forward contract to purchase domestic stock. (i) When Stock X is trading at $50 per share, Foreign Investor enters into a forward contract to purchase 100 shares of Stock X in one year. Reasonable estimates of the quarterly dividend are specified in the transaction documents. The price in the forward contract is determined by multiplying the number of shares referenced in the contract by the current price of the shares and an interest rate, and subtracting the value of any dividends expected to be paid during the term of the contract. Assuming that the forward contract is priced using an interest rate of 4 percent and total estimated dividends with a future value of $1 per share during the term of the forward contract, the purchase price set in the forward contract is $5,100 (100 shares × $50 per share × 1.04 − ($1 × 100)).

(ii) Subject to paragraph (i)(2)(iv) of this section, the estimated dividend amounts are the per-share dividend amounts because the estimates are reasonable and specified in accordance with paragraph (i)(2)(iii) of this section. The estimated per-share dividend amounts are dividend equivalents for purposes of this section.

Example 2. Price return only swap contract. (i) Foreign Investor enters into a price return swap contract that entitles Foreign Investor to receive payments based on the appreciation in the value of 100 shares of Stock X and requires Foreign Investor to pay an amount based on LIBOR plus any depreciation in the value of Stock X. The swap contract neither explicitly entitles Foreign Investor to payments based on dividends paid on Stock X during the term of the contract nor references an estimated dividend amount. The LIBOR rate in the swap contract, however, is reduced to reflect expected annual dividends on Stock X.

(ii) Because the LIBOR leg of the swap contract is reduced to reflect estimated dividends and the estimated dividend amounts are not specified, Foreign Investor is treated as receiving the actual dividend amounts are in accordance with paragraph (i)(2) of this section. The actual per-share dividend amounts are dividend equivalents for purposes of this section.

(j) *Amount of dividend equivalent*—(1) *Calculation of the amount of a dividend equivalent*—(i) *Securities lending or sale-repurchase transactions.* For a securities lending or sale-repurchase transaction, the amount of the dividend equivalent for each underlying security equals the amount of the actual per-share dividend paid on the underlying security multiplied by the number of shares of the underlying security.

(ii) *Simple contracts.* For a simple contract that is a section 871(m) transaction, the amount of the dividend equivalent for each underlying security equals:

(A) The per-share dividend amount (as determined under either paragraph (i)(2) or (i)(3) of this section) with respect to the underlying security multiplied by;

(B) The number of shares of the underlying security multiplied by;

(C) The delta of the section 871(m) transaction with respect to the underlying security.

(iii) *Complex contracts.* For a complex contract that is a section 871(m) transaction, the amount of the dividend equivalent for each underlying security equals:

(A) The per-share dividend amount (as determined under paragraph (i)(2) or (i)(3) of this section) with respect to the underlying security multiplied by;

(B) The initial hedge for the underlying security.

(iv) *Other substantially similar payments.* In addition to any amount determined pursuant to paragraph (j)(1)(i), (ii), or (iii), the amount of a dividend equivalent includes the amount of any payment described in paragraph (f) of this section.

(2) *Time for determining the amount of a dividend equivalent.* The amount of a dividend equivalent is determined on the earlier of the date that is the record date of the dividend and the day prior to the ex-dividend date with respect to the dividend. For example, if a specified NPC provides for a payment at settlement that takes into account an earlier dividend payment, the amount of the dividend equivalent is determined on the earlier of the record date or the day prior to the ex-dividend date for that dividend.

(3) *Number of shares.* The number of shares of an underlying security generally is the number of shares of the underlying security stated in the contract. If the transaction modifies that number by a factor or fraction or otherwise alters the amount of any payment, the number of shares is adjusted

to take into account the factor, fraction, or other modification. For example, in a transaction in which the long party receives or makes payments based on 200 percent of the appreciation or depreciation (as applicable) of 100 shares of stock, the number of shares of the underlying security is 200 shares of the stock.

(k) *Limitation on the treatment of certain corporate acquisitions as section 871(m) transactions.* A potential section 871(m) transaction is not a section 871(m) transaction with respect to an underlying security if the transaction obligates the long party to acquire ownership of the underlying security as part of a plan pursuant to which one or more persons (including the long party) are obligated to acquire underlying securities representing more than 50 percent of the value of the entity issuing the underlying securities.

(l) *Rules relating to indices*—(1) *Purpose.* The purpose of this section is to provide a safe harbor for potential section 871(m) transactions that reference certain passive indices that are based on a diverse basket of publicly-traded securities and that are widely used by numerous market participants. Notwithstanding any other provision in this paragraph (l), an index is not a qualified index if treating the index as a qualified index would be contrary to the purpose described in this paragraph.

(2) *Qualified index not treated as an underlying security.* For purposes of this section, a qualified index is treated as a single security that is not an underlying security. The determination of whether an index referenced in a potential section 871(m) transaction is a qualified index is made at the time the transaction is issued based on whether the index is a qualified index on the first business day of the calendar year in which the transaction is issued.

(3) *Qualified index.* A *qualified index* means an index that—

(i) References 25 or more component securities (whether or not the security is an underlying security);

(ii) Except as provided in paragraph (l)(6)(ii) of this section, references only long positions in component securities;

(iii) References no component underlying security that represents more than 15 percent of the weighting of the component securities in the index;

(iv) References no five or fewer component underlying securities that together represent more than 40 percent of the weighting of the component securities in the index;

(v) Is modified or rebalanced only according to publicly stated, predefined criteria, which may require interpretation by the index provider or a board or committee responsible for maintaining the index;

(vi) Did not provide an annual dividend yield in the immediately preceding calendar year from component underlying securities that is greater than 1.5 times the annual dividend yield of the S&P 500 Index as reported for the immediately preceding calendar year; and

(vii) Is traded through futures contracts or option contracts (regardless of whether the contracts provide price only or total return exposure to the index or provide for dividend reinvestment in the index) on—

(A) A national securities exchange that is registered with the Securities and Exchange Commission or a domestic board of trade designated as a contract market by the Commodity Futures Trading Commission; or

(B) A foreign exchange or board of trade that is a qualified board or exchange as determined by the Secretary pursuant to section 1256(g)(7)(C) or that has a staff no action letter from the CFTC permitting direct access from the United States that is effective on the applicable testing date, provided that the referenced component underlying securities, in the aggregate, comprise less than 50 percent of the weighting of the component securities in the index.

(4) *Safe harbor for certain indices that reference assets other than underlying securities.* Notwithstanding paragraph (l)(3) of this section, an index is a qualified index if the referenced component underlying securities in the aggregate comprise 10 percent or less of the weighting of the component securities in the index.

(5) *Weighting of component securities.* For purposes of this paragraph (l), the weighting of a component security of an index is the percentage of the

index's value represented, or accounted for, by the component security.

(6) *Transactions that reference a qualified index and one or more component securities or indices*—(i) *In general.* When a potential section 871(m) transaction references a qualified index and one or more component securities or other indices, the qualified index remains a qualified index only if the potential section 871(m) transaction does not reference a short position in any referenced component security of the qualified index, other than a short position with respect to the entire qualified index (for example, a cap or floor) or a de minimis short position described in paragraph (l)(6)(ii) of this section. If, in connection with a potential section 871(m) transaction that references a qualified index, a taxpayer (or a related person within the meaning of section 267(b) or section 707(b)) enters into one or more transactions that reduce exposure to any referenced component security of the index, other than transactions that reduce exposure to the entire index, then the potential section 871(m) transaction is not treated as referencing a qualified index.

(ii) *Safe harbor for de minimis short positions.* Notwithstanding paragraphs (l)(3)(ii) and (l)(6)(i) of this section, an index may be a qualified index if the short position (whether part of the index or entered into separately by the taxpayer or related person within the meaning of section 267(b) or section 707(b)) reduces exposure to referenced component securities of a qualified index (excluding any short positions with respect to the entire qualified index) by five percent or less of the value of the long positions in component securities in the qualified index.

(7) *Transactions that indirectly reference a qualified index.* If a potential section 871(m) transaction references a security (for example, stock in an exchange-traded fund) that tracks a qualified index, the potential section 871(m) transaction will be treated as referencing a qualified index.

(m) *Rules relating to derivatives that reference partnerships*—(1) *In general.* When a potential section 871(m) transaction references a partnership interest, the assets of the partnership will be treated as referenced by the potential section 871(m) transaction only if the partnership carries on a trade or business of dealing or trading in securities, holds significant investments in securities (either of which is a covered partnership), or directly or indirectly holds an interest in a lower-tier partnership that is a covered partnership. For purposes of this section, if a covered partnership directly or indirectly holds assets that are underlying securities or potential section 871(m) transactions, any potential section 871(m) transaction that references an interest in the covered partnership is treated as referencing the shares of the underlying securities, including underlying securities of potential section 871(m) transactions, directly or indirectly allocable to that partnership interest. For purposes of this paragraph (m), a security is defined in section 475(c).

(2) *Significant investments in securities*—(i) *In general.* For purposes of this paragraph (m), a partnership holds significant investments in securities if either—

(A) 25 percent or more of the value of the partnership's assets consist of underlying securities or potential section 871(m) transactions; or

(B) The value of the underlying securities or potential section 871(m) transactions equals or exceeds $25 million.

(ii) *Determining the value of the partnership's assets.* For purposes of this paragraph (m)(2), the value of a partnership's assets is determined at the time the potential 871(m) transaction referencing that partnership interest is issued based on the value of the assets held by the partnership on the last day of the partnership's prior taxable year unless the long party or the short party has actual knowledge that a subsequent transaction has caused the partnership to cross either of the thresholds described in paragraph (m)(2)(i). The value of a partnership's assets is equal to their fair market value, except that the value of any NPC, futures contract, forward contract, option, and any similar financial instrument held by the partnership is deemed to be the value of the notional securities referenced by the transaction.

(n) *Combined transactions*—(1) *In general.* For purposes of determining

whether a potential section 871(m) transaction is a section 871(m) transaction, two or more potential section 871(m) transactions are treated as a single transaction with respect to an underlying security when—

(i) A person (or a related person within the meaning of section 267(b) or section 707(b)) is the long party with respect to the underlying security for each potential section 871(m) transaction;

(ii) The potential section 871(m) transactions reference the same underlying security;

(iii) The potential section 871(m) transactions, when combined, replicate the economics of a transaction that would be a section 871(m) transaction if the transactions had been entered into as a single transaction; and

(iv) The potential section 871(m) transactions are entered into in connection with each other (regardless of whether the transactions are entered into simultaneously or with the same counterparty).

(2) *Section 871(m) transactions.* If a potential section 871(m) transaction is a section 871(m) transaction, either by itself or as a result of a combination with one or more other potential section 871(m) transactions, it does not cease to be a section 871(m) transaction as a result of applying paragraph (n) of this section or disposing of one or more of the potential section 871(m) transaction with which it is combined.

(3) *Short party presumptions regarding combined transactions*—(i) *Transactions in separate accounts.* A short party that is a broker may presume that transactions are not entered into in connection with each other for purposes of paragraph (n)(1) of this section if a long party holds or reflects the transactions in separate accounts maintained by the short party, unless the short party has actual knowledge that the transactions held or reflected in separate accounts by the long party were entered into in connection with each other or that separate accounts were created or used to avoid section 871(m).

(ii) *Transactions separated by at least two business days.* A short party that is a broker may presume that transactions entered into two or more business days apart are not entered into in connection with each other for purposes of paragraph (n)(1) of this section unless the short party has actual knowledge that the transactions were entered into in connection with each other.

(4) *Presumptions Commissioner will apply to long party*—(i) *Transactions in separate trading books.* The Commissioner will presume that a long party did not enter into two or more transactions in connection with each other for purposes of paragraph (n)(1) of this section if the long party properly reflected those transactions on separate trading books. The Commissioner may rebut this presumption with facts and circumstances showing that transactions reflected on separate trading books were entered into in connection with each other or that separate trading books were created or used to avoid section 871(m).

(ii) *Transactions separated by at least two days.* The Commissioner will presume that a long party did not enter into two or more transactions in connection with each other for purposes of paragraph (n)(1) of this section if the long party entered into the transactions two or more business days apart. The Commissioner may rebut this presumption with facts and circumstances showing that the transactions entered into two or more business days apart were entered into in connection with each other.

(iii) *Transactions separated by less than two days and reflected in the same trading book.* The Commissioner will presume that transactions that are entered into less than two business days apart and reflected on the same trading book are entered into in connection with each other. A long party can rebut this presumption with facts and circumstances showing that the transactions were not entered into in connection with each other.

(5) *Rules of application*—(i) *Two business days rule.* For the purpose of determining the number of business days between transactions, the short party may, and the Commissioner will, assume that all transactions are entered into at 4:00 p.m. on the date the transaction becomes effective in the jurisdiction of the long party.

(ii) *No long party presumptions.* Notwithstanding the presumptions described in paragraphs (n)(3) and (n)(4) of this section, the long party must treat two or more transactions as combined transactions if the transactions are described in paragraph (n)(1) of section.

(6) *Ordering rule for transactions entered into in connection with each other.* If a long party enters into more than two potential section 871(m) transactions that could be combined under this paragraph (n), a short party is required to apply paragraph (n)(1) of this section by combining transactions in a manner that results in the most transactions with a delta of 0.8 or higher with respect to the referenced underlying security. Thus, for example, if a taxpayer has sold one at-the-money put and purchased two at-the-money calls, each with respect to 100 shares of the same underlying security, the put and one call are combined. Similarly, a purchased call on 100 shares and a sold put on 200 shares of the same underlying security can be combined for 100 shares with 100 shares of the put remaining separate. The two calls are not combined because they do not provide the long party with economic exposure to depreciation in the underlying security. Similarly, if a long party enters into more than two potential section 871(m) transactions that could be combined under this paragraph (n), but have not been combined by a short party, the long party is required to apply paragraph (n)(1) of this section by combining transactions in a manner that results in the most transactions with a delta of 0.8 or higher with respect to the referenced underlying security.

(7) *More than one underlying security referenced.* If potential section 871(m) transactions reference more than one underlying security, paragraph (n)(1) of this section applies separately with respect to each underlying security.

(o) *Anti-abuse rule.* If a taxpayer (directly or through the use of a related person within the meaning of section 267(b) or section 707(b)) acquires (whether by entering into, purchasing, accepting by transfer, by exchange, or by conversion, or otherwise acquiring) or disposes of (whether by sale, offset, exercise, termination, expiration, maturity, or other means) a transaction or transactions with a principal purpose of avoiding the application of this section, the Commissioner may treat any payment (as described in paragraph (i) of this section) made with respect to that transaction or transactions as a dividend equivalent to the extent necessary to prevent the avoidance of this section. Therefore, notwithstanding any other provision of this section, the Commissioner may, for example, adjust the delta of a transaction, change the number of shares, adjust an estimated dividend amount, change the maturity, adjust the timing of payments, treat a transaction that references a partnership interest as referencing the assets of the partnership, combine, separate, or disregard transactions, indices, or components of indices to reflect the substance of the transaction or transactions, or otherwise depart from the rules of this section as necessary to determine whether the transaction includes a dividend equivalent or the amount or timing of a dividend equivalent. A purpose may be a principal purpose even though it is outweighed by other purposes (taken together or separately). When a withholding agent knows that the taxpayer acquired or disposed of a transaction or transactions with a principal purpose of avoiding the application of this section and the Commissioner treats a payment made with respect to any transaction as a dividend equivalent, the withholding agent may be liable for any tax pursuant to section 1461.

(p) *Information required to be reported regarding a potential section 871(m) transaction*—(1) *In general.* If a broker or dealer is a party to a potential section 871(m) transaction with a counterparty or customer that is not a broker or dealer, the broker or dealer is required to determine whether the potential section 871(m) transaction is a section 871(m) transaction. If both parties to a potential section 871(m) transaction are brokers or dealers, or neither party to a potential section 871(m) transaction is a broker or dealer, the short party must determine whether the potential section 871(m) transaction is a section 871(m) transaction. The party

to the transaction that is required to determine whether a transaction is a section 871(m) transaction must also determine and report to the counterparty or customer the timing and amount of any dividend equivalent (as described in paragraphs (i) and (j) of this section). Except as otherwise provided in paragraph (n)(3) of this section, the party required to make the determinations described in this paragraph is required to exercise reasonable diligence to determine whether a transaction is a section 871(m) transaction, the amount of any dividend equivalents, and any other information necessary to apply the rules of this section. The information must be provided in the manner prescribed in paragraphs (p)(2) and (p)(3) of this section. The determinations required by paragraph (p) of this section are binding on the parties to the potential section 871(m) transaction and on any person who is a withholding agent with respect to the potential section 871(m) transaction unless the person knows or has reason to know that the information received is incorrect. The determinations are not binding on the Commissioner.

(2) *Reporting requirements.* For rules regarding the reporting requirements of withholding agents with respect to dividend equivalents described in this section, see §§ 1.1461–1(b) and (c) and 1.1474–1(c) and (d).

(3) *Additional information available to a party to a potential section 871(m) transaction*—(i) *In general.* Upon request by any person described in paragraph (p)(3)(ii) of this section, the party required to report information pursuant to paragraph (p)(1) of this section must provide the requester with information regarding the amount of each dividend equivalent, the delta of the potential section 871(m) transaction, the amount of any tax withheld and deposited, the estimated dividend amount if specified in accordance with paragraph (i)(2)(iii) of this section, the identity of any transactions combined pursuant to paragraph (n) of this section, and any other information necessary to apply the rules of this section. The information requested must be provided within a reasonable time, not to exceed 10 business days, and communicated in one or more of the following ways:

(A) By telephone, and confirmed in writing;

(B) By written statement sent by first class mail to the address provided by the requesting party;

(C) By electronic publication available to all persons entitled to request information; or

(D) By any other method agreed to by the parties, and confirmed in writing.

(ii) *Persons entitled to request information.* Any party to the transaction described in paragraph (a)(9) of this section may request the information specified in paragraph (p) of this section with respect to a potential section 871(m) transaction from the party required by paragraph (p)(3)(i) of this section to provide the information.

(iii) *Reliance on information received.* A person described in paragraph (p)(1) or (p)(3)(ii) of this section that receives information described in paragraph (p)(1) or (p)(3)(i) of this section may rely on that information to provide information to any other person unless the recipient knows or has reason to know that the information received is incorrect. When the recipient knows or has reason to know that the information received is incorrect, the recipient must make a reasonable effort to determine and provide the information described in paragraph (p)(1) or (p)(3)(i) of this section to any person described in paragraph (p)(1) or (p)(3)(ii) of this section that requests information from the recipient.

(4) *Recordkeeping rules*—(i) *In general.* For rules regarding recordkeeping requirements sufficient to establish whether a transaction is a section 871(m) transaction and whether a payment is a dividend equivalent and the amount of gross income treated as a dividend equivalent, see § 1.6001–1.

(ii) *Records sufficient to establish whether a transaction is a section 871(m) transaction and any dividend equivalent amount.* Any person required to retain records must keep sufficient information to establish whether a transaction is a section 871(m) transaction and the amount of a dividend equivalent (if any), including documentation and work papers supporting the delta calculation or the substantial equivalence test (including the number of shares of

the initial hedge), as applicable, and written estimated dividends (if any). The records and documentation must be created substantially contemporaneously. A record will be considered to have been created substantially contemporaneously if it was created within 10 business days of the date the potential section 871(m) transaction is issued.

(q) *Dividend and dividend equivalent payments to a qualified derivatives dealer.* [Reserved]. For further guidance, see § 1.871–15T(q).

(r) *Effective/applicability date*—(1) *In general.* This section applies to payments made on or after September 18, 2015 except as provided in paragraphs (r)(2), (3), and (4) of this section.

(2) *Effective/applicability date for paragraph (d)(1)(i).* Paragraph (d)(1)(i) of this section applies to payments made on or after January 23, 2012.

(3) *Effective/applicability date for paragraphs (d)(2) and (e).* Paragraphs (d)(2) and (e) of this section apply to any payment made on or after January 1, 2017, with respect to any transaction issued on or after January 1, 2017.

(4) *Effective/applicability date for paragraphs (c)(2)(iv), (h), and (q) of this section.* [Reserved]. For further guidance, see § 1.871–15T(r)(4).

[T.D. 9648, 78 FR 73080, Dec. 5, 2013, as amended by T.D. 9734, 80 FR 56879, Sept. 18, 2015; 80 FR 75946, Dec. 7, 2015]

§ 1.871–15T Treatment of dividend equivalents (temporary).

(a) through (b) [Reserved]. For further guidance, see § 1.871–15(a) through (b).

(c) [Reserved]. For further guidance, see § 1.871–15(c)(1) through (c)(2)(iii).

(iv) *Payments made pursuant to annuity, endowment, and life insurance contracts*—(A) *Insurance contracts issued by domestic insurance companies.* A payment made pursuant to a contract that is an annuity, endowment, or life insurance contract issued by a domestic corporation (including its foreign or U.S. possession branch) that is a life insurance company described in section 816(a) does not include a dividend equivalent if the payment is subject to tax under section 871(a) or section 881.

(B) *Insurance contracts issued by foreign insurance companies.* A payment does not include a dividend equivalent if it is made pursuant to a contract that is an annuity, endowment, or life insurance contract issued by a foreign corporation that is predominantly engaged in an insurance business and that would be subject to tax under subchapter L if it were a domestic corporation.

(C) *Insurance contracts held by foreign insurance companies.* A payment made pursuant to a policy of insurance (including a policy of reinsurance) does not include a dividend equivalent if it is made to a foreign corporation that is predominantly engaged in an insurance business and that would be subject to tax under subchapter L if it were a domestic corporation.

(v) [Reserved]. For further guidance, see § 1.871–15(c)(2)(v).

(d) through (g) [Reserved]. For further guidance, see § 1.871–15(d) through (g).

(h) *Substantial equivalence test*—(1) *In general.* The substantial equivalence test described in this paragraph (h) applies to determine whether a complex contract is a section 871(m) transaction. The substantial equivalence test assesses whether a complex contract substantially replicates the economic performance of the underlying security by comparing, at various testing prices for the underlying security, the differences between the expected changes in value of that complex contract and its initial hedge with the differences between the expected changes in value of a simple contract benchmark (as described in paragraph (h)(2) of this section) and its initial hedge. If the complex contract contains more than one reference to a single underlying security, all references to that underlying security are taken into account for purposes of applying the substantial equivalence test with respect to that underlying security. With respect to an equity derivative that is embedded in a debt instrument or other derivative, the substantial equivalence test is applied to the complex contract without taking into account changes in the market value of the debt instrument or other derivative that are not directly related to the equity element of the instrument. The complex contract is a section 871(m)

transaction with respect to an underlying security if, for that underlying security, the expected change in value of the complex contract and its initial hedge is equal to or less than the expected change in value of the simple contract benchmark and its initial hedge when the substantial equivalence test described in this paragraph (h) is calculated at the time the complex contract is issued. To the extent that the steps of the substantial equivalence test set out in this paragraph (h) cannot be applied to a particular complex contract, a taxpayer must use the principles of the substantial equivalence test to reasonably determine whether the complex contract is a section 871(m) transaction with respect to each underlying security. For purposes of this section, the test must be applied and the inputs must be determined in a commercially reasonable manner. If a taxpayer calculates any relevant input for non-tax business purposes, that input ordinarily is the input used for purposes of this section.

(2) *Simple contract benchmark.* The simple contract benchmark is a closely comparable simple contract that, at the time the complex contract is issued, has a delta of 0.8, references the applicable underlying security referenced by the complex contract, and has the same maturity as the complex contract with respect to the applicable underlying security. Depending on the complex contract, the simple contract benchmark might be, for example, a call option, a put option, or a collar.

(3) *Substantial equivalence.* A complex contract is a section 871(m) transaction with respect to an underlying security if the complex contract calculation described in paragraph (h)(4) of this section results in an amount that is equal to or less than the amount of the benchmark calculation described in paragraph (h)(5) of this section.

(4) *Complex contract calculation*—(i) *In general.* The complex contract calculation for each underlying security referenced by a potential section 871(m) transaction that is a complex contract is computed by:

(A) Determining the change in value (as described in paragraph (h)(4)(ii) of this section) of the complex contract with respect to the underlying security at each testing price (as described in paragraph (h)(4)(iii) of this section);

(B) Determining the change in value of the initial hedge for the complex contract at each testing price;

(C) Determining the absolute value of the difference between the change in value of the complex contract determined in paragraph (h)(4)(i)(A) of this section and the change in value of the initial hedge determined in paragraph (h)(4)(i)(B) of this section at each testing price;

(D) Determining the probability (as described in paragraph (h)(4)(iv) of this section) associated with each testing price;

(E) Multiplying the absolute value for each testing price determined in paragraph (h)(4)(i)(C) of this section by the corresponding probability for that testing price determined in paragraph (h)(4)(i)(D) of this section;

(F) Adding the product of each calculation determined in paragraph (h)(4)(i)(E) of this section; and

(G) Dividing the sum determined in paragraph (h)(4)(i)(F) of this section by the initial hedge for the complex contract.

(ii) *Determining the change in value.* The change in value of a complex contract is the difference between the value of the complex contract with respect to the underlying security at the time the complex contract is issued and the value of the complex contract with respect to the underlying security if the price of the underlying security were equal to the testing price at the time the complex contract is issued. The change in value of the initial hedge of a complex contract with respect to the underlying security is the difference between the value of the initial hedge at the time the complex contract is issued and the value of the initial hedge if the price of the underlying security were equal to the testing price at the time the complex contract is issued.

(iii) *Testing price.* The testing prices must include the prices of the underlying security if the price of the underlying security at the time the complex contract is issued were alternatively increased by one standard deviation

and decreased by one standard deviation, each of which is a separate testing price. In circumstances where using only two testing prices is reasonably likely to provide an inaccurate measure of substantial equivalence, a taxpayer must use additional testing prices as necessary to determine whether a complex contract satisfies the substantial equivalence test. If additional testing prices are used for the substantial equivalence test, the probabilities as described in paragraph (h)(4)(iv) of this section must be adjusted accordingly.

(iv) *Probability*. For purposes of paragraphs (h)(4)(i)(D) and (E) of this section, the probability of an increase by one standard deviation is the measure of the likelihood that the price of the underlying security will increase by any amount from its price at the time the complex contract is issued. For purposes of paragraphs (h)(4)(i)(D) and (E) of this section, the probability of a decrease by one standard deviation is the measure of the likelihood that the price of the underlying security will decrease by any amount from its price at the time the complex contract is issued.

(5) *Benchmark calculation*. The benchmark calculation with respect to each underlying security referenced by the potential section 871(m) transaction is determined by using the computation methodology described in paragraph (h)(4) of this section with respect to a simple contract benchmark for the underlying security.

(6) *Substantial equivalence calculation for certain complex contracts that reference multiple underlying securities*. If a complex contract references 10 or more underlying securities and the short party uses an exchange-traded security (for example, an exchange-traded fund) that references substantially all of the underlying securities (the hedge security) to hedge the complex contract at the time it is issued, the substantial equivalence calculations for the complex contract may be calculated by treating the hedge security as the underlying security. When the hedge security is used for the substantial equivalence calculation pursuant to this paragraph (h)(6), the initial hedge is the number of shares of the hedge security for purposes of calculating the amount of a dividend equivalent as provided in paragraph (j)(1)(iii) of this section.

(7) *Example*. The following example illustrates the rules of paragraph (h) of this section. For purposes of this example, Stock X is common stock of domestic corporation X. FI is the financial institution that structures the transaction described in the example, and is the short party to the transaction. Investor is a nonresident alien individual.

Example. Complex contract that is not substantially equivalent. (i) FI issues an investment contract (the Contract) that has a stated maturity of one year, and Investor purchases the Contract from FI at issuance for $10,000. At maturity, the Contract entitles Investor to a return of $10,000 (i) plus 200 percent of any appreciation in Stock X above $100 per share, capped at $110, on 100 shares or (ii) minus 100 percent of any depreciation in Stock X below $90 on 100 shares. At the time FI issues the Contract, the price of Stock X is $100 per share. Thus, for example, Investor will receive $11,000 if the price of Stock X is $105 per share at maturity of the Contract, but Investor will receive $9,000 if the price of Stock X is $80 per share when the Contract matures. At issuance, FI acquires 64 shares of Stock X to fully hedge the Contract issued to Investor.

(ii) The Contract references an underlying security and is not an NPC, so it is classified as an ELI under paragraph (a)(4) of this section. At issuance, the Contract does not provide for an amount paid at maturity that is calculated by reference to a single, fixed number of shares of Stock X. When the Contract matures, the amount paid is effectively calculated based on either 200 shares of Stock X (if the price of Stock X has appreciated up to $110) or 100 shares of Stock X (if the price of Stock X has declined below $90). Consequently, the Contract is a complex contract described in paragraph (a)(14) of this section.

(iii) Because it is a complex ELI, FI applies the substantial equivalence test described in paragraph (h) of this section to determine whether the Contract is a specified ELI. FI determines that the price of Stock X would be $120 if the price of Stock X were increased by one standard deviation, and $79 if the price of Stock X were decreased by one standard deviation. Based on these results, FI next determines the change in value of the Contract to be $2,000 at the testing price that represents an increase by one standard deviation ($12,000 testing price minus $10,000 issue price) and a negative $1,100 at the testing price that represents a decrease by one

standard deviation ($10,000 issue price minus $8,900 testing price). FI performs the same calculations for the 64 shares of Stock X that constitute the initial hedge, determining that the change in value of the initial hedge is $1,280 at the testing price that represents an increase by one standard deviation ($6,400 at issuance compared to $7,680 at the testing price) and negative $1,344 at the testing price that represents a decrease by one standard deviation ($6,400 at issuance compared to $5,056 at the testing price).

(iv) FI then determines the absolute value of the difference between the change in value of the initial hedge and the Contract at the testing price that represents an increase by one standard deviation and a decrease by one standard deviation. Increased by one standard deviation, the absolute value of the difference is $720 ($2,000 − $1,280); decreased by one standard deviation, the absolute value of the difference is $244 (negative $1,100 minus negative $1,344). FI determines that there is a 52% chance that the price of Stock X will have increased in value when the Contract matures and a 48% chance that the price of Stock X will have decreased in value at that time. FI multiplies the absolute value of the difference between the change in value of the initial hedge and the Contract at the testing price that represents an increase by one standard deviation by 52%, which equals $374.40. FI multiplies the absolute value of the difference between the change in value of the initial hedge and the Contract at the testing price that represents a decrease by one standard deviation by 48%, which equals $117.12. FI adds these two numbers and divides by the number of shares that constitute the initial hedge to determine that the complex contract calculation is 7.68 ((374.40 plus 117.12) divided by 64).

(v) FI then performs the same calculation with respect to the simple contract benchmark, which is a one-year call option that references one share of Stock X, settles on the same date as the Contract, and has a delta of 0.8. The one-year call option has a strike price of $79 and has a cost (the purchase premium) of $22. The initial hedge for the one-year call option is 0.8 shares of Stock X.

(vi) FI first determines that the change in value of the simple contract benchmark is $19.05 if the testing price is increased by one standard deviation ($22.00 at issuance to $41.05 at the testing price) and negative $20.95 if the testing price is decreased by one standard deviation ($22.00 at issuance to $1.05 at the testing price). Second, FI determines that the change in value of the initial hedge is $16.00 at the testing price that represents an increase by one standard deviation ($80 at issuance to $96 at the testing price) and negative $16.80 at the testing price that represents a decrease by one standard deviation ($80.00 at issuance to $63.20 at the testing price).

(vii) FI determines the absolute value of the difference between the change in value of the initial hedge and the one-year call option at the testing price that represents an increase by one standard deviation is $3.05 ($16.00 minus $19.05). FI next determines the absolute value of the difference between the change in value of the initial hedge and the option at the testing price that represents a decrease by one standard deviation is $4.15 (negative $16.80 minus negative $20.95). FI multiplies the absolute value of the difference between the change in value of the initial hedge and the option at the testing price that represents an increase by one standard deviation by 52%, which equals $1.586. FI multiplies the absolute value of the difference between the change in value of the initial hedge and the option at the testing price that represents a decrease by one standard deviation by 48%, which equals $1.992. FI adds these two numbers and divides by the number of shares that constitute the initial hedge to determine that the benchmark calculation is 4.473 ((1.586 plus 1.992) divided by .8).

(viii) FI concludes that the Contract is not a section 871(m) transaction because the complex contract calculation of 7.68 exceeds the benchmark calculation of 4.473.

(i) through (p) [Reserved]. For further guidance, see §1.871–15(i) through (p).

(q) *Dividend and dividend equivalent payments to a qualified derivatives dealer*—(1) *In general.* Except as otherwise provided in this paragraph (q), a qualified derivatives dealer described in §1.1441–1(e)(6) that receives a dividend or the payment of a dividend equivalent (within the meaning of paragraph (i) of this section) in its dealer capacity will not be liable for tax under section 871 or section 881 provided that the qualified derivatives dealer complies with its obligations under the qualified intermediary agreement described in §§1.1441–1(e)(5) and 1.1441–1(e)(6). If a qualified derivatives dealer receives a dividend or dividend equivalent payment on or determined by reference to an underlying security and the offsetting dividend equivalent payment the qualified derivatives dealer is contractually obligated to make on the same underlying security is less than the dividend and dividend equivalent amount received (including when the

qualified derivatives dealer is not contractually obligated to make an offsetting dividend equivalent payment), the qualified derivatives dealer is liable for tax under section 871 or section 881 for the difference. For purposes of this paragraph (q), a dividend or dividend equivalent is not treated as received by a qualified derivatives dealer acting in its dealer capacity if the dividend or dividend equivalent is received by the qualified derivatives dealer acting as a proprietary trader. Transactions properly reflected in a qualified derivatives dealer's dealer book are presumed to be held by a dealer in its dealer capacity for purposes of this paragraph (q).

(2) *Examples*. The following examples illustrate the rules of this paragraph (q):

Example 1. Forward contract entered into by a foreign dealer. (i) *Facts*. FB is a foreign bank that is a qualified intermediary that acts as a qualified derivatives dealer. On April 1, Year 1, FB enters into a cash settled forward contract initiated by a foreign customer (Customer) that entitles Customer to receive from FB all of the appreciation and dividends on 100 shares of Stock X, and obligates Customer to pay FB any depreciation on 100 shares of Stock X, at the end of three years. FB hedges the forward contract by entering into a total return swap contract with a domestic broker (U.S. Broker) and maintains the swap contract as a hedge for the duration of the forward contract. The swap contract entitles FB to receive an amount equal to all of the dividends on 100 shares of Stock X and obligates FB to pay an amount referenced to a floating interest rate each quarter, and also entitles FB to receive from or pay to U.S. Broker, as the case may be, the difference between the value of 100 shares of Stock X at the inception of the swap and the value of 100 shares of Stock X at the end of 3 years. FB provides valid documentation to U.S. Broker that FB will receive payments under the swap contract in its capacity as a qualified derivatives dealer, and FB contemporaneously enters both the swap contract with U.S. Broker and the forward contract with Customer on its dealer books. Stock X pays a quarterly dividend of $0.25 per share.

(ii) *Application of rules*. FB is a long party on a delta one contract (the total return swap) and a short party on a delta one contract (the forward contract with Customer). U.S. Broker is not obligated to withhold on the dividend equivalent payments to FB on the swap contract that are referenced to Stock X dividends, however, because U.S. Broker has received valid documentation that it may rely upon to treat the payment as made to FB acting as a qualified derivatives dealer. Similarly, FB is not obligated to pay tax on the payments it receives from U.S. Broker referenced to Stock X dividends because at the time it received the payments FB was contractually obligated to make fully offsetting dividend equivalent payments as the short party with respect to 100 shares of Stock X to Customer. FB is required to withhold on dividend equivalent payments to Customer on the forward contract in accordance with § 1.1441–2(e)(8).

Example 2. At-the-money option contract entered into by a foreign dealer. (i) *Facts*. The facts are the same as Example 1, but customer purchases from FB an at-the-money call option on 100 shares of Stock X with a term of one year. The call option has a delta of 0.5 and FB hedges the call option by purchasing 50 shares of Stock X, which are held in an account with U.S. Broker, who also acts as paying agent.

(ii) *Application of rules*. FB is a long party on 50 shares of Stock X and a short party on an option. Because the option has a delta of less than 0.8 on the date it was issued, it is not a section 871(m) transaction. U.S. Broker is not obligated to withhold on the Stock X dividends paid to FB because U.S. Broker has received valid documentation that it may rely upon to treat the dividends as paid to FB acting as a qualified derivatives dealer. FB is liable for tax under section 871 or section 881 on the Stock X dividends it receives from U.S. Broker, however, because at the time it received the dividends FB was not contractually obligated to make an offsetting dividend equivalent payment to Customer. FB is not required to make an offsetting dividend equivalent payment to Customer because the option has a delta of 0.5; therefore, it is not a section 871(m) transaction.

Example 3. In-the-money option contract entered into by a foreign dealer. (i) *Facts*. The facts are the same as Example 2, but Customer purchases from FB an in-the-money call option on 100 shares of Stock X with a term of one year. The call option has a delta of 0.8 and FB hedges the call option by purchasing 80 shares of Stock X, which are held in an account with U.S. Broker, who also acts as paying agent. The price of Stock X declines substantially and the option lapses unexercised.

(ii) *Application of rules*. FB is a long party on 80 shares of Stock X and a short party on an option. Because the option has a delta of 0.8 on the date it was issued, it is a section 871(m) transaction. U.S. Broker is not obligated to withhold on the Stock X dividends paid to FB because U.S. Broker has received valid documentation that it may rely upon to treat the dividends as paid to FB acting as a qualified derivatives dealer. Similarly, FB is not obligated to pay tax on the Stock X dividends it receives from U.S. Broker to the

extent that FB is contractually obligated to make offsetting dividend equivalent payments as the short party to Customer. FB is required to withhold on dividend equivalent payments to Customer on the option contract in accordance with §1.1441–2(e)(8). FB is also liable for tax under section 871 or section 881 on Stock X dividends, if any, that exceed the dividend equivalent payment to Customer.

(r)(1) through (3) [Reserved]. For further guidance, see §1.871–15(r)(1) through (3).

(4) *Effective/applicability date.* This section applies to payments made on or after January 1, 2017.

(s) *Expiration date.* This section expires September 17, 2018.

[T.D. 9734, 80 FR 56885, Sept. 18, 2015, as amended by 80 FR 75946, Dec. 7, 2015]

§ 1.872–1 Gross income of nonresident alien individuals.

(a) *In general*—(1) *Inclusions.* The gross income of a nonresident alien individual for any taxable year includes only (i) the gross income which is derived from sources within the United States and which is not effectively connected for the taxable year with the conduct of a trade or business in the United States by that individual and (ii) the gross income, irrespective of whether such income is derived from sources within or without the United States, which is effectively connected for the taxable year with the conduct of a trade or business in the United States by that individual. For the determination of the sources of income, see sections 861 through 863 and the regulations thereunder. For the determination of whether income from sources within or without the United States is effectively connected for the taxable year with the conduct of a trade or business in the United States, see sections 864(c) and 871 (c) and (d), §§1.864–3 through 1.864–7, and §§1.871–9 and 1.871–10. For special rules for determining the income of an alien individual who changes his residence during the taxable year, see §1.871–13.

(2) *Exchange transactions.* Even though a nonresident alien individual who effects certain transactions in the United States in stocks, securities, or commodities during the taxable year may not, by reason of section 864(b)(2) and paragraph (c) or (d) of §1.864–2, be engaged in trade or business in the United States during the taxable year through the effecting of such transactions, nevertheless he shall be required to include in gross income for the taxable year the gains and profits from those transactions to the extent required by §1.871–7 or §1.871–8.

(3) *Exclusions.* For exclusions from gross income, see §1.872–2.

(b) *Individuals not engaged in U.S. business.* In the case of a nonresident alien individual who at no time during the taxable year is engaged in trade or business in the United States, the gross income shall include only (1) the gross income from sources within the United States which is described in section 871(a) and paragraphs (b), (c), and (d) of §1.871–7, and (2) the gross income from sources within the United States which, by reason of section 871 (c) or (d) and §1.871–9 or §1.871–10, is treated as effectively connected for the taxable year with the conduct of a trade or business in the United States by that individual.

(c) *Individuals engaged in U.S. business.* In the case of a nonresident alien individual who is engaged in trade or business in the United States at any time during the taxable year, the gross income shall include (1) the gross income from sources within and without the United States which is effectively connected for the taxable year with the conduct of a trade or business in the United States by that individual, (2) the gross income from sources within the United States which, by reason of the election provided in section 871(d) and §1.871–10, is treated as effectively connected for the taxable year with the conduct of a trade or business in the United States by that individual, and (3) the gross income from sources within the United States which is described in section 871(a) and paragraphs (b), (c), and (d) of §1.871–7 and is not effectively connected for the taxable year with the conduct of a trade or business in the United States by that individual.

(d) *Special rules applicable to certain expatriates.* For special rules for determining the gross income of a nonresident alien individual who has lost U.S. citizenship with a principal purpose of avoiding certain taxes, see section 877(b)(1).

(e) *Alien resident of Puerto Rico*. This section shall not apply in the case of a nonresident alien individual who is a bona fide resident of Puerto Rico during the entire taxable year. See section 876 and § 1.876–1.

(f) *Effective date*. This section shall apply for taxable years beginning after December 31, 1966. For corresponding rules applicable to taxable years beginning before January 1, 1967, see 26 CFR 1.872–1 (Revised as of January 1, 1971).

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 7332, 39 FR 44228, Dec. 23, 1974]

§ 1.872–2 Exclusions from gross income of nonresident alien individuals.

(a) *Earnings of foreign ships or aircraft*—(1) *Basic rule*. So much of the income from sources within the United States of a nonresident alien individual as consists of earnings derived from the operation of a ship or ships documented, or of aircraft registered, under the laws of a foreign country which grants an equivalent exemption to citizens of the United States nonresident in that foreign country and to corporations organized in the United States shall not be included in gross income.

(2) *Equivalent exemption*—(i) *Ships*. A foreign country which either imposes no income tax, or, in imposing an income tax, exempts from taxation so much of the income of a citizen of the U.S. nonresident in that foreign country and of a corporation organized in the United States as consists of earnings derived from the operation of a ship or ships documented under the laws of the United States is considered as granting an equivalent exemption for purposes of the exclusion from gross income of the earnings of a foreign ship or ships.

(ii) *Aircraft*. A foreign country which either imposes no income tax, or, in imposing an income tax, exempts from taxation so much of the income of a citizen of the U.S. nonresident in that foreign country and of a corporation organized in the United States as consists of earnings derived from the operation of aircraft registered under the laws of the United States is considered as granting an equivalent exemption for purposes of the exclusion from gross income of the earnings of foreign aircraft.

(3) *Definition of earnings*. For purposes of subparagraphs (1) and (2) of this paragraph, compensation for personal services performed by an individual aboard a ship or aircraft does not constitute earnings derived by such individual from the operation of ships or aircraft.

(b) *Compensation paid by foreign employer to participants in certain exchange or training programs*—(1) *Exclusion from income*. Compensation paid to a nonresident alien individual for the period that the nonresident alien individual is temporarily present in the United States as a nonimmigrant under subparagraph (F) (relating to the admission of students into the United States) or subparagraph (J) (relating to the admission of teachers, trainees, specialists, etc., into the United States) of section 101(a)(15) of the Immigration and Nationality Act (8 U.S.C. 1101(a)(15) (F) or (J)) shall be excluded from gross income if the compensation is paid to such alien by his foreign employer. Compensation paid to a nonresident alien individual by the U.S. office of a domestic bank which is acting as paymaster on behalf of a foreign employer constitutes compensation paid by a foreign employer for purposes of this paragraph if the domestic bank is reimbursed by the foreign employer for such payment. A nonresident alien individual who is temporarily present in the United States as a nonimmigrant under such subparagraph (J) includes a nonresident alien individual admitted to the United States as an ''exchange visitor'' under section 201 of the U.S. Information and Educational Exchange Act of 1948 (22 U.S.C. 1446), which section was repealed by section 111 of the Mutual Education and Cultural Exchange Act of 1961 (75 Stat. 538).

(2) *Definition of foreign employer*. For purposes of this paragraph, the term ''foreign employer'' means a nonresident alien individual, a foreign partnership, a foreign corporation, or an office or place of business maintained in a foreign country or in a possession of the United States by a domestic corporation, a domestic partnership, or an individual who is a citizen or resident of the United States.

The term does not include a foreign government. However, see section 893 and § 1.893–1. Thus, if a French citizen employed in the Paris branch of a banking company incorporated in the State of New York were admitted to the United States under section 101(a)(15)(J) of the Immigration and Nationality Act to study monetary theory and continued to receive a salary from such foreign branch while studying in the United States, such salary would not be includable in his gross income.

(c) *Tax convention.* Income of any kind which is exempt from tax under the provisions of a tax convention or treaty to which the United States is a party shall not be included in the gross income of a nonresident alien individual. Income on which the tax is limited by tax convention shall be included in the gross income of a nonresident alien individual if it is not otherwise excluded from gross income. See §§ 1.871–12 and 1.894–1.

(d) *Certain bond income of residents of the Ryukyu Islands or the Trust Territory of the Pacific Islands.* Income derived by a nonresident alien individual from a series E or series H U.S. savings bond shall not be included in gross income if such individual acquired the bond while he was a resident of the Ryukyu Islands or the Trust Territory of the Pacific Islands. It is not necessary that the individual continue to be a resident of such Islands or Trust Territory for the period when, without regard to section 872(b)(4) and this paragraph, the income from the bond would otherwise be includible in his gross income under the provisions of section 446 or 454.

(e) *Certain annuities received under qualified plans.* Pursuant to section 871(f), income received by a nonresident alien individual as an annuity under a qualified annuity plan described in section 403(a)(1) (relating to taxation of employee annuities), or from a qualified trust described in section 401(a) (relating to qualified pension, profit-sharing, and stock bonus plans) which is exempt from tax under section 501(a) (relating to exemption from tax on corporations, certain trusts, etc.), shall not be included in gross income, and shall be exempt from tax, for purposes of section 871 and §§ 1.871–7 and 1.871–8, if—

(1) All of the personal services by reason of which the annuity is payable were either—

(i) Personal services performed outside the United States by an individual (whether or not the annuitant) who, at the time of performance of the services, was a nonresident alien individual, or

(ii) Personal services performed in the United States by a nonresident alien individual (whether or not the annuitant) which, by reason of section 864(b)(1) (or corresponding provision of any prior law), were not personal services causing such individual to be engaged in trade or business in the United States during the taxable year, and

(2) At the time the first amount is paid (even though paid in a taxable year beginning before January 1, 1967) as such annuity under such annuity plan, or by such trust, to (i) the individual described in subparagraph (1) of this paragraph, or (ii) his nonresident alien beneficiary if such beneficiary is entitled to receive such first amount, 90 percent or more of the employees or annuitants for whom contributions or benefits are provided under the annuity plan, or under the plan or plans of which the trust is a part, are citizens or residents of the United States.

This paragraph shall apply whether or not the taxpayer is engaged in trade or business in the United States at any time during the taxable year in which the annuity is received. This paragraph shall not apply to distributions by an employees' trust or from an annuity plan which give rise to gains described in section 402(a)(2) or 403(a)(2), whichever applies. See section 871(a)(1)(B) and paragraph (c)(1)(i) of § 1.871–7. For exemption from withholding of tax at source on an annuity which is exempt from tax under section 871(f) and this paragraph, see paragraph (g) of § 1.1441–4.

(f) *Other exclusions.* Income which is from sources without the United States, as determined under the provisions of sections 861 through 863, and the regulations thereunder, is not included in the gross income of a nonresident alien individual unless such

income is effectively connected for the taxable year with the conduct of a trade or business in the United States by that individual. To determine specific exclusions in the case of other items which are from sources within the United States, see the applicable sections of the Code. For special rules under a tax convention for determining the sources of income and for excluding, from gross income, income from sources without the United States which is effectively connected with the conduct of a trade or business in the United States, see the applicable tax convention. For determining which income from sources without the United States is effectively connected with the conduct of a trade or business in the United States, see section 864(c)(4) and § 1.864–5.

(g) *Effective date*. This section shall apply for taxable years beginning after December 31, 1966. For corresponding rules applicable to taxable years beginning before January 4, 1967 see 26 CFR 1.872–2 (Revised as of January 1, 1971).

[T.D. 7332, 39 FR 44228, Dec. 23, 1974]

§ 1.873–1 Deductions allowed nonresident alien individuals.

(a) *General provisions*—(1) *Allocation of deductions*. In computing the taxable income of a nonresident alien individual the deductions otherwise allowable shall be allowed only if, and to the extent that, they are connected with income from sources within the United States. No deduction shall be allowed in respect of any item, or portion thereof, which is not connected with income from such sources. For this purpose, the proper apportionment and allocation of the deductions with respect to sources of income within and without the United States shall be determined as provided in part I (section 861 and following), subchapter N, chapter 1 of the Code, and the regulations thereunder, except as may otherwise be provided by tax convention. Thus, from the items of gross income specifically from sources within the United States and from the items allocated thereto under the provisions of section 863(a), there shall be deducted (i) the expenses, losses, and other deductions which are connected with those items of income and are properly apportioned or allocated thereto, and (ii) a ratable part of any other expenses, losses, or deductions which are connected with those items of income but cannot definitely be allocated to some item or class of gross income. The ratable part shall be based upon the ratio of gross income from sources within the United States to the total gross income. See §§ 1.861–8 and 1.863–1. In the case of income partly from within and partly from without the United States the expenses, losses, and other deductions connected with income from sources within the United States shall also be deducted in the manner prescribed by §§ 1.863–2 through 1.863–5 in order to ascertain under section 863 the portion of the taxable income attributable to sources within the United States.

(2) *Personal exemptions*. The deductions for the personal exemptions allowed by section 151 or 642(b) shall not be taken into account for purposes of subparagraph (1) of this paragraph but shall be allowed to the extent provided by paragraphs (b) and (c) of this section.

(3) *Adjusted gross income*. The adjusted gross income of a nonresident alien individual shall be the gross income from sources within the United States, determined in accordance with § 1.871–7, minus the deductions prescribed by section 62 to the extent such deductions are allowed under this section in computing taxable income.

(4) *Standard deduction*. The standard deduction shall not be allowed in computing the taxable income of a nonresident alien individual. See section 142(b)(1) and the regulations thereunder.

(5) *Exempt income*. No deduction shall be allowed under this section for the amount of any item or part thereof allocable to a class or classes of exempt income, including income exempt by tax convention. See section 265 and the regulations thereunder.

(b) *No United States business*—(1) *Income of not more than $15,400*—(i) *Deduction for losses only*. A nonresident alien individual within class 1 shall not be allowed any deductions other than the deduction for losses from sales or exchanges of capital assets determined in the manner prescribed by paragraph

(b)(4)(vii) of § 1.871–7. Thus, an individual within this class shall not be allowed any deductions for the personal exemptions otherwise allowed by section 151 or 642(b).

(ii) *Source of losses.* Notwithstanding the provisions of section 873(b)(1), losses from sales or exchanges of capital assets shall be allowed under this subparagraph only if allocable to sources within the United States. See paragraph (b)(4)(i) of § 1.871–7.

(2) *Aggregate more than $15,400*—(i) *Deductions allowed.* In computing the income subject to tax under section 1 or section 1201(b), a nonresident alien individual within class 2 shall be allowed deductions to the extent prescribed by paragraph (c)(3) of § 1.871–7, but subject to the limitations of this section. For this purpose, the deduction for the personal exemptions shall be allowed in accordance with subdivision (iii) of this subparagraph.

(ii) *Deductions disallowed.* In computing the minimum tax prescribed by section 871(b)(3), that individual shall not be allowed any deductions other than the deduction for losses from sales or exchanges of capital assets determined in the manner prescribed by paragraph (b)(4)(vii) of § 1.871–7. For this purpose, the deductions for the personal exemptions shall not be allowed. See paragraph (c)(4) of § 1.871–7.

(iii) *Personal exemptions.* When the deductions for personal exemptions are allowed under this subparagraph, only one exemption under section 151 shall be allowed in the case of an individual who is not a resident of Canada or Mexico. A resident of either of those countries shall be allowed all the exemptions granted by section 151 to the extent prescribed therein. An estate or trust, whether or not a resident of Canada or Mexico, shall determine its deduction for the personal exemption in accordance with section 642(b) and the regulations thereunder.

(iv) *Source of losses.* Notwithstanding the provisions of section 873(b), losses from sales or exchanges of capital assets shall be allowed under this subparagraph only if allocable to sources within the United States. See paragraph (c)(3)(i) of § 1.871–7.

(3) *Election to be taxed on a net basis.* Notwithstanding the other provisions of this paragraph, a nonresident alien individual within class 1 or 2 shall be allowed the deductions allowed by paragraph (c) of this section, if pursuant to a tax convention he is entitled, and does elect, to be subject to United States tax on a net basis as though he were engaged in trade or business within the United States through a permanent establishment situated therein.

(c) *United States business*—(1) *Deductions in general.* For purposes of computing the income subject to tax, a nonresident alien individual within class 3 shall be allowed deductions to the extent prescribed by paragraph (d) of § 1.871–7, but subject to the limitations of this section. For this purpose, the deductions for the personal exemptions shall be allowed in accordance with subparagraph (3) of this paragraph.

(2) *Special deductions.* Notwithstanding the rule of source prescribed in paragraph (a) of this section, an individual within class 3 shall be allowed the following deductions whether or not they are connected with income from sources within the United States:

(i) *Losses on transactions for profit.* Any loss sustained during the taxable year and not compensated for by insurance or otherwise, if incurred in any transaction entered into for profit, though not connected with a trade or business, shall be allowed to the extent allowed by section 165(c)(2), but only if and to the extent that the profit, if the transaction had resulted in a profit, would be taxable to such individual. Losses allowed under this subdivision shall be deducted in full, as provided in §§ 1.861–8 and 1.863–1, when the profit from the transaction, if it had resulted in a profit, would, under the provisions of section 861(a) or 863(a), have been taxable in full as income from sources within the United States; but shall be deducted under the provisions of § 1.863–3 when the profit from the transaction, if it had resulted in profit, would have been taxable only in part.

(ii) *Casualty losses.* Any loss of property not connected with a trade or business, sustained during the taxable year and not compensated for by insurance or otherwise, if the loss arises from fire, storm, shipwreck, or other

casualty, or from theft, shall be allowed to the extent allowed by section 165(c)(3), but only if the loss is of property within the United States. Losses allowed under this subdivision shall be deducted in full, as provided in §§ 1.861–8 and 1.863–1, from the items of gross income specified under sections 861(a) and 863(a) as being derived in full from sources within the United States; but, if greater than the sum of those items, the unabsorbed loss shall be deducted from the income apportioned under the provisions of § 1.863–3 to sources within the United States.

(iii) *Charitable contributions.* The deduction for charitable contributions and gifts, to the extent allowed by section 170, shall be allowed under this subparagraph, but only as to contributions or gifts made to domestic corporations, or to community chests, funds, or foundations, created in the United States.

(3) *Personal exemptions.* Only one exemption under section 151 shall be allowed in the case of an individual who is not a resident of Canada or Mexico. A resident of either of those countries shall be allowed all the exemptions granted by section 151 to the extent prescribed therein. An estate or trust, whether or not a resident of Canada or Mexico, shall determine its deduction for the personal exemption in accordance with section 642(b) and the regulations thereunder.

§ 1.874–1 Allowance of deductions and credits to nonresident alien individuals.

(a) *Return required.* A nonresident alien individual shall receive the benefit of the deductions and credits otherwise allowable with respect to the income tax, only if the nonresident alien individual timely files or causes to be filed with the Philadelphia Service Center, in the manner prescribed in subtitle F, a true and accurate return of the income which is effectively connected, or treated as effectively connected, with the conduct of a trade or business within the United States by the nonresident alien individual. No provision of this section (other than paragraph (c)(2)) shall be construed, however, to deny the credits provided by sections 31, 32, 33, 34 and 852(b)(3)(D)(ii). In addition, notwithstanding the requirement that a nonresident alien must file a timely return in order to receive the benefit of the deductions and credits otherwise allowable with respect to the income tax, the nonresident alien individual may, for purposes of determining the amount of tax to be withheld under section 1441 from remuneration paid for labor or personal services performed within the United States, receive the benefit of the deduction for personal exemptions provided in section 151, to the extent allowable under section 873(b)(3) and paragraph (c)(3) of § 1.873–1, or in any applicable tax convention, by filing a claim therefore with the withholding agent. The amount of the deduction for the personal exemptions and the amount of the tax to be withheld under those circumstances shall be determined in accordance with paragraph (e)(2) of § 1.1441–3. The deductions and credits allowed such a nonresident alien individual electing under a tax convention to be subject to tax on a net basis may be obtained by filing a return of income in the manner prescribed in the regulations (if any) under the tax convention or under any other guidance issued by the Commissioner.

(b) *Filing deadline for return*—(1) *General rule.* As provided in paragraph (a) of this section, for purposes of computing the nonresident alien individual's taxable income for any taxable year, otherwise allowable deductions and credits will be allowed only if a true and accurate return for that taxable year is filed by the nonresident alien individual on a timely basis. For taxable years of a nonresident alien individual ending after July 31, 1990, whether a return for the current taxable year has been filed on a timely basis is dependent upon whether the nonresident alien individual filed a return for the taxable year immediately preceding the current taxable year. If a return was filed for that immediately preceding taxable year, or if the current taxable year is the first taxable year of the nonresident alien individual for which a return is required to be filed, the required return for the current taxable year must be filed within 16 months of the due date, as set forth

in section 6072 and the regulations under that section, for filing the return for the current taxable year. If no return for the taxable year immediately preceding the current taxable year has been filed, the required return for the current taxable year (other than the first taxable year of the nonresident alien individual for which a return is required to be filed) must have been filed no later than the earlier of the date which is 16 months after the due date, as set forth in section 6072, for filing the return for the current taxable year or the date the Internal Revenue Service mails a notice to the nonresident alien individual advising the nonresident alien individual that the current year tax return has not been filed and that no deductions or credits (other than those provided in sections 31, 32, 33, 34 and 852(b)(3)(D)(ii)) may be claimed by the nonresident alien individual.

(2) *Waiver*. The filing deadlines set forth in paragraph (b)(1) of this section may be waived if the nonresident alien individual establishes to the satisfaction of the Commissioner or his or her delegate that the individual, based on the facts and circumstances, acted reasonably and in good faith in failing to file a U.S. income tax return (including a protective return (as described in paragraph (b)(6) of this section)). For this purpose, a nonresident alien individual shall not be considered to have acted reasonably and in good faith if the individual knew that he or she was required to file the return and chose not to do so. In addition, a nonresident alien individual shall not be granted a waiver unless the individual cooperates in determining his or her U.S. income tax liability for the taxable year for which the return was not filed. The Commissioner or his or her delegate shall consider the following factors in determining whether the nonresident alien individual, based on the facts and circumstances, acted reasonably and in good faith in failing to file a U.S. income tax return—

(i) Whether the individual voluntarily identifies himself or herself to the Internal Revenue Service as having failed to file a U.S. income tax return before the Internal Revenue Service discovers the failure to file;

(ii) Whether the individual did not become aware of his or her ability to file a protective return (as described in paragraph (b)(6) of this section) by the deadline for filing the protective return;

(iii) Whether the individual had not previously filed a U.S. income tax return;

(iv) Whether the individual failed to file a U.S. income tax return because, after exercising reasonable diligence (taking into account his or her relevant experience and level of sophistication), the individual was unaware of the necessity for filing the return;

(v) Whether the individual failed to file a U.S. income tax return because of intervening events beyond the individual's control; and

(vi) Whether other mitigating or exacerbating factors existed.

(3) *Examples*. The following examples illustrate the provisions of paragraph (b). In all examples, A is a nonresident alien individual and uses the calendar year as A's taxable year. The examples are as follows:

Example 1. Nonresident alien individual discloses own failure to file. In Year 1, A became a limited partner with a passive investment in a U.S. limited partnership that was engaged in a U.S. trade or business. During Year 1 through Year 4, A incurred losses with respect to A's U.S. partnership interest. A's foreign tax advisor incorrectly concluded that because A was a limited partner and had only losses from A's partnership interest, A was not required to file a U.S. income tax return. A was aware neither of A's obligation to file a U.S. income tax return for those years nor of A's ability to file a protective return for those years. A had never filed a U.S. income tax return before. In Year 5, A began realizing a profit rather than a loss with respect to the partnership interest and, for this reason, engaged a U.S. tax advisor to handle A's responsibility to file U.S. income tax returns. In preparing A's U.S. income tax return for Year 5, A's U.S. tax advisor discovered that returns were not filed for Year 1 through Year 4. Therefore, with respect to those years for which applicable filing deadlines in paragraph (b)(1) of this section were not met, A would be barred by paragraph (a) of this section from claiming any deductions that otherwise would have given rise to net operating losses on returns for these years, and that would have been available as loss carryforwards in subsequent years. At A's direction, A's U.S. tax advisor promptly contacted the appropriate examining personnel and cooperated with the Internal Revenue

Service in determining A's income tax liability, for example, by preparing and filing the appropriate income tax returns for Year 1 through Year 4 and by making A's books and records available to an Internal Revenue Service examiner. A has met the standard described in paragraph (b)(2) of this section for waiver of any applicable filing deadlines in paragraph (b)(1) of this section.

Example 2. Nonresident alien individual refuses to cooperate. Same facts as in *Example 1,* except that while A's U.S. tax advisor contacted the appropriate examining personnel and filed the appropriate income tax returns for Year 1 through Year 4, A refused all requests by the Internal Revenue Service to provide supporting information (for example, books and records) with respect to those returns. Because A did not cooperate in determining A's U.S. tax liability for the taxable years for which an income tax return was not timely filed, A is not granted a waiver as described in paragraph (b)(2) of this section of any applicable filing deadlines in paragraph (b)(1) of this section.

Example 3. Nonresident alien individual fails to file a protective return. Same facts as in *Example 1,* except that in Year 1 through Year 4, A also consulted a U.S. tax advisor, who advised A that it was uncertain whether U.S. income tax returns were necessary for those years and that A could protect A's right subsequently to claim the loss carryforwards by filing protective returns under paragraph (b)(6) of this section. A did not file U.S. income tax returns or protective returns for those years. A did not present evidence that intervening events beyond A's control prevented A from filing an income tax return, and there were no other mitigating factors. A has not met the standard described in paragraph (b)(2) of this section for waiver of any applicable filing deadlines in paragraph (b)(1) of this section.

Example 4. Nonresident alien with effectively connected income. In Year 1, A, a computer programmer, opened an office in the United States to market and sell a software program that A had developed outside the United States. A had minimal business or tax experience internationally, and no such experience in the United States. Through A's personal efforts, U.S. sales of the software produced income effectively connected with a U.S. trade or business. A, however, did not file U.S. income tax returns for Year 1 or Year 2. A was aware neither of A's obligation to file a U.S. income tax return for those years, nor of A's ability to file a protective return for those years. A had never filed a U.S. income tax return before. In November of Year 3, A engaged U.S. counsel in connection with licensing software to an unrelated U.S. company. U.S. counsel reviewed A's U.S. activities and advised A that A should have filed U.S. income tax returns for Year 1 and Year 2. A immediately engaged a U.S. tax advisor who, at A's direction, promptly contacted the appropriate examining personnel and cooperated with the Internal Revenue Service in determining A's income tax liability, for example, by preparing and filing the appropriate income tax returns for Year 1 and Year 2 and by making A's books and records available to an Internal Revenue Service examiner. A has met the standard described in paragraph (b)(2) of this section for waiver of any applicable filing deadlines in paragraph (b)(1) of this section.

Example 5. IRS discovers nonresident alien's failure to file. In Year 1, A, a computer programmer, opened an office in the United States to market and sell a software program that A had developed outside the United States. Through A's personal efforts, U.S. sales of the software produced income effectively connected with a U.S. trade or business. A had extensive experience conducting similar business activities in other countries, including making the appropriate tax filings. A, however, was aware neither of A's obligation to file a U.S. income tax return for those years, nor of A's ability to file a protective return for those years. A had never filed a U.S. income tax return before. Despite A's extensive experience conducting similar business activities in other countries, A made no effort to seek advice in connection with A's U.S. tax obligations. A failed to file either U.S. income tax returns or protective returns for Year 1 and Year 2. In November of Year 3, an Internal Revenue Service examiner asked A for an explanation of A's failure to file U.S. income tax returns. A immediately engaged a U.S. tax advisor, and cooperated with the Internal Revenue Service in determining A's income tax liability, for example, by preparing and filing the appropriate income tax returns for Year 1 and Year 2 and by making A's books and records available to the examiner. A did not present evidence that intervening events beyond A's control prevented A from filing a return, and there were no other mitigating factors. A has not met the standard described in paragraph (b)(2) of this section for waiver of any applicable filing deadlines in paragraph (b)(1) of this section.

Example 6. Nonresident alien with prior filing history. A began a U.S. trade or business in Year 1 as a sole proprietorship. A's tax advisor filed the appropriate U.S. income tax returns for Year 1 through Year 6, reporting income effectively connected with A's U.S. trade or business. In Year 7, A replaced this tax advisor with a tax advisor unfamiliar with U.S. tax law. A did not file a U.S. income tax return for any year from Year 7 through Year 10, although A had effectively connected income for those years. A was aware of A's ability to file a protective return for those years. In Year 11, an Internal Revenue Service examiner contacted A and asked for an explanation of A's failure to file

income tax returns after Year 6. A immediately engaged a U.S. tax advisor and cooperated with the Internal Revenue Service in determining A's income tax liability, for example, by preparing and filing the appropriate income tax returns for Year 7 through Year 10 and by making A's books and records available to the examiner. A did not present evidence that intervening events beyond A's control prevented A from filing a return, and there were no other mitigating factors. A has not met the standard described in paragraph (b)(2) of this section for waiver of any applicable filing deadlines in paragraph (b)(1) of this section.

(4) *Effective date.* Paragraphs (b)(2) and (3) of this section are applicable to open years for which a request for a waiver is filed on or after January 29, 2002.

(5) *Income tax treaties.* A nonresident alien individual who has a permanent establishment or fixed base, as defined in an income tax treaty between the United States and the country of residence of the nonresident alien individual, in the United States is subject to the filing deadlines as set forth in paragraph (b)(1) of this section.

(6) *Protective return.* If a nonresident alien individual conducts limited activities in the United States in a taxable year which the nonresident alien individual determines does not give rise to gross income which is effectively connected with the conduct of a trade or business within the United States as defined in sections 871(b) and 864 (b) and (c) and the regulations under those sections, the nonresident alien individual may nonetheless file a return for that taxable year on a timely basis under paragraph (b)(1) of this section and thereby protect the right to receive the benefit of the deductions and credits attributable to that gross income if it is later determined, after the return was filed, that the original determination was incorrect. On that timely filed return, the nonresident alien individual is not required to report any gross income as effectively connected with a United States trade or business or any deductions or credits but should attach a statement indicating that the return is being filed for the reason set forth in this paragraph (b)(4). If the nonresident alien individual determines that part of the activities which he or she conducts in the United States in a taxable year gives rise to gross income which is effectively connected with the conduct of a trade or business and part does not, the nonresident alien individual must timely file a return for that taxable year to report the gross income determined to be effectively connected, or treated as effectively connected, with the conduct of that trade or business within the United States and the deductions and credits attributable to the gross income. In addition, the nonresident alien individual should attach to that return the statement described in this paragraph (b)(4) with regard to the other activities. The nonresident alien individual may follow the same procedure if the nonresident alien individual determines initially that he or she has no United States tax liability under the provisions of an applicable income tax treaty. In the event the nonresident alien individual relies on the provisions of an income tax treaty to reduce or eliminate the income subject to taxation, or to reduce the rate of tax to which that income is subject, disclosure may be required pursuant to section 6114.

(c) *Allowed deductions and credits*—(1) *In general.* Except for losses of property located within the United States, charitable contributions and personal exemptions (see section 873(b)), deductions are allowed to a nonresident alien individual only to the extent they are connected with gross income which is effectively connected, or treated as effectively connected, with the conduct of the nonresident alien individual's trade or business in the United States. Other than credits allowed by sections 31, 32, 33, 34, and 852(b)(3)(D)(ii), the nonresident alien individual is entitled to credits only if they are attributable to effectively connected income. See paragraph (a) of this section for the requirement that a return be timely filed. Except as provided by section 906, a nonresident alien individual shall not be allowed the credit against the tax for taxes of foreign countries and possessions of the United States allowed by section 901.

(2) *Verification.* At the request of the Internal Revenue Service, a nonresident alien individual claiming deductions from gross income which is effectively connected or treated as effectively connected, with the conduct of a trade or business in the United States and credits attributable to that income must furnish at the place designated pursuant to § 301.7605–1(a) information sufficient to establish that the nonresident alien individual is entitled to the deductions and credits in the amounts claimed. All information must be furnished in a form suitable to permit verification of the claimed deductions and credits. The Internal Revenue Service may require, as appropriate, that an English translation be provided with any information in a foreign language. If a nonresident alien individual fails to furnish sufficient information, the Internal Revenue Service may in its discretion disallow any claimed deductions and credits in full or in part.

(d) *Return by Internal Revenue Service.* If a nonresident alien individual has various sources of income within the United States, so that from any one source, or from all sources combined, the amount of income shall call for the assessment of a tax greater than that withheld at the source in the case of that individual, and a return of income has not been filed in the manner prescribed by subtitle F, including the filing deadlines set forth in paragraph (b)(1) of this section, the Internal Revenue Service shall:

(1) Cause a return of income to be made,

(2) Include on the return the income described in § 1.871–7 or § 1.871–8 of that individual from all sources concerning which it has information, and

(3) *Assess the tax.* If the nonresident alien individual is not engaged in, or does not receive income that is treated as being effectively connected with, a United States trade or business and § 1.871–7 is applicable, the tax shall be assessed on the basis of gross income without allowance for deductions or credits (other than the credits provided by sections 31, 32, 33, 34 and 852(b)(3)(D)(ii)) and collected from one or more sources of income within the United States. If the nonresident alien individual is engaged in a United States trade or business or is treated as having effectively connected income and § 1.871–8 applies, the tax on the income of the nonresident alien individual that is not effectively connected, or treated as effectively connected with the conduct of a United States trade or business shall be assessed on the basis of gross income, determined in accordance with the rules of § 1.871–7, without allowance for deductions or credits (other than the credits provided by sections 31, 32, 33, 34 and 852(b)(3)(D)(ii)) and collected from one or more of the sources of income within the United States. Tax on income that is effectively connected, or treated as effectively connected, with the conduct of a United States trade or business shall be assessed in accordance with either section 1, 55 or 402(e)(1) without allowance for deductions or credits (other than the credits provided by sections 31, 32, 33, 34 and 852(b)(3)(D)(ii)) and collected from one or more of the sources of income within the United States.

(e) *Alien resident of Puerto Rico, Guam, American Samoa, or the Commonwealth of the Northern Mariana Islands.* This section shall not apply to a nonresident alien individual who is a bona fide resident of Puerto Rico, Guam, American Samoa, or the Commonwealth of the Northern Mariana Islands during the entire taxable year. *See* section 876 and § 1.876–1.

[T.D. 8322, 55 FR 50828, Dec. 11, 1990; 56 FR 1361, Jan. 14, 1991, as amended by T.D. 8981, 67 FR 4174, Jan. 29, 2002; T.D. 9043, 68 FR 11313, Mar. 10, 2003]

§ 1.875–1 Partnerships.

Whether a nonresident alien individual who is a member of a partnership is taxable in accordance with subsection (a), (b), or (c) of section 871 may depend on the status of the partnership. A nonresident alien individual who is a member of a partnership which is not engaged in trade or business within the United States is subject to the provisions of section 871 (a) or (b), as the case may be, depending on whether or not he receives during the taxable year an aggregate of more than

$15,400 gross income described in section 871(a), if he is not otherwise engaged in trade or business within the United States. A nonresident alien individual who is a member of a partnership which at any time within the taxable year is engaged in trade or business within the United States is considered as being engaged in trade or business within the United States and is therefore taxable under section 871(c). For definition of what the term ''partnership'' includes, see section 7701(a)(2) and the regulations in part 301 of this chapter (Regulations on Procedure and Administration). The test of whether a partnership is engaged in trade or business within the United States is the same as in the case of a nonresident alien individual. See § 1.871–8.

§ 1.875–2 Beneficiaries of estates or trusts.

(a) [Reserved]

(b) *Exception for certain taxable years.* Notwithstanding paragraph (a) of this section, for any taxable year beginning before January 1, 1975, the grantor of a trust, whether revocable or irrevocable, is not deemed to be engaged in trade or business within the United States merely because the trustee is engaged in trade or business within the United States.

(c) [Reserved]

[T.D. 7332, 39 FR 44233, Dec. 23, 1974]

§ 1.876–1 Alien residents of Puerto Rico, Guam, American Samoa, or the Northern Mariana Islands.

(a) *Scope.* Section 876 and this section apply to any nonresident alien individual who is a bona fide resident of Puerto Rico or of a section 931 possession during the entire taxable year.

(b) *In general.* An individual to whom this section applies is, in accordance with the provisions of section 876, subject to tax under sections 1 and 55 in generally the same manner as an alien resident of the United States. See §§ 1.1–1(b) and 1.871–1. The tax generally is imposed upon the taxable income of such individual, determined in accordance with section 63(a) and the regulations under that section, from sources both within and without the United States, except for amounts excluded from gross income under the provisions of section 931 or 933. For determining the form of return to be used by such an individual, see section 6012 and the regulations under that section.

(c) *Exceptions.* Though subject to the tax imposed by section 1, an individual to whom this section applies will nevertheless be treated as a nonresident alien individual for the purpose of many provisions of the Internal Revenue Code (Code) relating to nonresident alien individuals. Thus, for example, such an individual is not allowed the standard deduction (section 63(c)(6)); is subject to withholding of tax at source under chapter 3 of the Code (for example, section 1441(e)); is generally excepted from the collection of income tax at source on wages for services performed in the possession (section 3401(a)(6)); is not allowed to make a joint return (section 6013(a)(1)); and, if described in section 6072(c), must pay his first installment of estimated income tax on or before the 15th day of the 6th month of the taxable year (section 6654(j) and (k)) and must pay his income tax on or before the 15th day of the 6th month following the close of the taxable year (sections 6072(c) and 6151(a)). In addition, under section 152(b)(3), an individual is not allowed a deduction for a dependent who is a resident of the relevant possession unless the dependent is a citizen or national of the United States.

(d) *Credits against tax.* (1) Certain credits under the Internal Revenue Code are available to any taxpayer subject to the tax imposed by section 1, including individuals to whom this section applies. For example, except as otherwise provided under section 931 or 933, the credits provided by the following sections are allowable to the extent provided under such sections against the tax determined in accordance with this section—

(i) Section 23 (relating to the credit for adoption expenses);

(ii) Section 31 (relating to the credit for tax withheld on wages);

(iii) Section 33 (relating to the credit for tax withheld at source on nonresident aliens); and

(iv) Section 34 (relating to the credit for certain uses of gasoline and special fuels).

(2) Certain credits under the Internal Revenue Code are not available to nonresident aliens or are subject to limitations based on such factors as principal place of abode in the United States. For example, the credits provided by the following sections are not allowable against the tax determined in accordance with this section except to the extent otherwise provided under such sections—

(i) Section 22 (relating to the credit for the elderly and disabled);

(ii) Section 25A (relating to the Hope Scholarship and Lifetime Learning Credits); and

(iii) Section 32 (relating to the earned income credit).

(e) *Definitions*. For purposes of this section—

(1) ''Bona fide resident'' is defined in § 1.937–1; and

(2) ''Section 931 possession'' is defined in § 1.931–1(c)(1).

(f) *Effective/applicability date*. This section applies to taxable years ending after April 9, 2008.

[T.D. 9391, 73 FR 19358, Apr. 9, 2008]

§ 1.879–1 Treatment of community income.

(a) *Treatment of community income*—(1) *In general*. For taxable years beginning after December 31, 1976, community income of a citizen or resident of the United States who is married to a nonresident alien individual, and the deductions properly allocable to that income, shall be divided between the U.S. citizen or resident spouse in accordance with the rules in section 879 and paragraph (a)(2) through (a)(6) of this section. This section does not apply for any taxable year with respect to which an election under section 6013 (g) or (h) is in effect. Community income for this purpose includes all gross income, whether derived from sources within or without the United States, which is treated as community income of the spouses under the community property laws of the State, foreign country, or possession of the United States in which the recipient of the income is domiciled. Income from real property also may be community income if so treated under the laws of the jurisdiction in which the real property is located.

(2) *Earned income*. Wages, salaries, or professional fees, and other amounts received as compensation for personal services actually performed, which are community income for the taxable year, shall be treated as the income of the spouse who actually performed the personal services. This paragraph (a)(2) does not apply, however, to the following items of community income:

(i) Community income derived from any trade or business carried on by the husband or the wife.

(ii) Community income attributable to a spouse's distributive share of the income of a partnership to which paragraph (a)(4) of this section applies.

(iii) Community income consisting of compensation for personal services rendered to a corporation which represents a distribution of the earnings and profits of the corporation rather than a reasonable allowance as compensation for the personal services actually performed, but not including any income that would be treated as earned income under the second sentence of section 911(b).

(iv) Community income derived from property which is acquired as consideration for personal services performed.

These items of community income are divided in accordance with the rules in paragraph (a)(3) through (a)(6) of this section.

(3) *Trade or business income*. If any income derived from a trade or business carried on by the husband or wife is community income for the taxable year, all of the gross income, and the deductions attributable to that income, shall be treated as the gross income and deductions of the husband. However, if the wife exercises substantially all of the management and control of the trade or business, all of the gross income and deductions shall be treated as the gross income and deductions of the wife. This paragraph (a)(3) does not apply to any income derived from a trade or business carried on by a partnership of which both or one of the spouses is a member (see paragraph (a)(4) of this section). For purposes of this paragraph (a)(3), income derived from a trade or business includes any income derived from a trade or business in which both personal services

and capital are material income producing factors. The term ''management and control'' means management and control in fact, not the management and control imputed to the husband under the community property laws of a State, foreign country or possession of the United States. For example, a wife who operates a pharmacy without any appreciable collaboration on the part of a husband is considered as having substantially all of the management and control of the business despite the provisions of any community property laws of a State, foreign country, or possession of the United States, vesting in the husband the right of management and control of community property. The income and deductions attributable to the operation of the pharmacy are considered the income and deductions of the wife.

(4) *Partnership income.* If any portion of a spouse's distributive share of the income of a partnership, of which the spouse is a member, is community income for the taxable year, all of that distributive share shall be treated as the income of that spouse and shall not be taken into account in determining the income of the other spouse. If both spouses are members of the same partnership, the distributive share of the income of each spouse which is community income shall be treated as the income of that spouse. A spouse's distributive share of the income of a partnership that is community income shall be determined as provided in section 704 and the regulations thereunder.

(5) *Income from separate property.* Any community income for the taxable year, other than income described in section 879(a) (1) or (2) and paragraph (a) (2), (3), or (4) of this section, which is derived from the separate property of one of the spouses shall be treated as the income of that spouse. The determination of what property is separate property for this purpose shall be made in accordance with the laws of the State, foreign country, or possession of the United States in which, in accordance with paragraph (a)(1) of this section, the recipient of the income is domiciled or, in the case of income from real property, in which the real property is located.

(6) *Other community income.* Any community income for the taxable year, other than income described in section 879(a) (1), (2), or (3), and paragraph (a) (2), (3), (4), or (5) of this section, shall be treated as income of that spouse who has a proprietary vested interest in that income under the laws of the state, foreign country, or possession of the United States in which, in accordance with paragraph (a)(1) of this section, the recipient of the income is domiciled or, in the case of income from real property, in which the real property is located. Thus, for example, this paragraph (a)(6) applies to community income not described in paragraph (a) (2), (3), (4), or (5) of this section which consists of dividends, interest, rents, royalties, or gains, from community property or of the earnings of unemancipated minor children.

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

Example 1. H, a U.S. citizen, and W, a nonresident alien individual, each of whose taxable years is the calendar year, were married throughout 1977. H and W were residents of, and domiciled in, foreign country Z during the entire taxable year. No election under section 6013 (g) or (h) is in effect for 1977. During 1977, H earned $10,000 from the performance of personal services as an employee. H also received $500 in dividend income from stock which under the community property laws of country Z is considered to be the separate property of H. W had no separate income for 1977. Under the community property laws of country Z all income earned by either spouse is considered to be community income, and one-half of this income is considered to belong to the other spouse. In addition, the laws of country Z provide that all income derived from property held separately by either spouse is to be treated as community income and treated as belonging one-half to each spouse. Thus, under the community property laws of country Z, H and W are both considered to have realized income of $5,250 during 1977, even though Z's laws recognize the stock as the separate property of H. Under the rules of paragraph (a) (2) and (5) of this section all of the income of $10,500 derived during 1977 is treated, for U.S. income tax purposes, as the income of H.

Example 2. (a) The facts are the same as in example 1, except that H is the sole proprietor of a retail merchandising company, which has a $10,000 profit during 1977. W exercises no management and control over the business. In addition, H is a partner in a

wholesale distributing company, and his distributive share of the partnership profit is $5,000. Both of these amounts of income are treated as community income under the community property laws of country Z, and under these laws both H and W are treated as realizing $7,500 of the income. Under the rule of paragraph (a) (3) and (4) of this section all $15,000 of the income is treated as the income of H for U.S. income tax purposes.

(b) If W exercises substantially all of the management and control over the retail merchandising company, then for U.S. income tax purposes the $10,000 profit is treated as the income of W.

Example 3. The facts are the same as in example 1, except that H also received $1,000 in dividends on stock held separately in his name. Under the community property laws of country Z the stock is considered to be community property, the dividends to be community income, and one-half of the income to be the income of each spouse. Under the rule of paragraph (a)(6) of this section, $500 of the dividend income is treated, for U.S. income tax purposes, as the income of each spouse.

(b) *Definitions and other special rules*—(1) *Spouses with different taxable years.* A special rule applies if the nonresident alien and the United States citizen or resident spouse of the alien do not have the same taxable years, as defined in section 441(b) and the regulations thereunder. The special rule is as follows. With respect to the U.S. citizen or resident spouse, section 879 and this section shall apply to each taxable year of the U.S. citizen or resident spouse for which no election under section 6013 (g) or (h) is in effect. With respect to the nonresident alien spouse, section 879 and this section apply to each period falling within the consecutive taxable years of the nonresident alien spouse which coincides with a taxable year of the U.S. citizen or resident spouse to which section 879 and this section apply.

(2) *Determination of marital status.* For purposes of this section, marital status shall be determined under section 143(a).

[T.D. 7670, 45 FR 6928, Jan. 31, 1980]

FOREIGN CORPORATIONS

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[T.D. 8611, 60 FR 41005, Aug. 11, 1995]

§ 1.881–1 Manner of taxing foreign corporations.

(a) *Classes of foreign corporations.* For purposes of the income tax, foreign corporations are divided into two classes, namely, foreign corporations which at no time during the taxable year are engaged in trade or business in the United States and foreign corporations which, at any time during the taxable year, are engaged in trade or business in the United States.

(b) *Manner of taxing*—(1) *Foreign corporations not engaged in U.S. business.* A foreign corporation which at no time during the taxable year is engaged in trade or business in the United States is taxable, as provided in § 1.881–2, on all income received from sources within the United States which is fixed or determinable annual or periodical income and on other items of income enumerated under section 881(a). Such a foreign corporation is also taxable on certain income from sources within the United States which, pursuant to § 1.882–2, is treated as effectively connected for the taxable year with the conduct of a trade or business in the United States.

(2) *Foreign corporations engaged in U.S. business.* A foreign corporation which at any time during the taxable year is engaged in trade or business in the United States is taxable, as provided in § 1.882–1, on all income from whatever source derived, whether or not fixed or determinable annual or periodical income, which is effectively connected for the taxable year with the conduct of a trade or business in the United States. Such a foreign corporation is also taxable, as provided in § 1.882–1, on income received from sources within the United States which is not effectively connected for the taxable year with the conduct of a trade or business in the United States and consists of (i) fixed or determinable annual or periodical income, or (ii) other items of income enumerated in section 881(a). A foreign corporation which at any time during the taxable year is engaged in trade or business in the United States is also taxable on certain income from sources within the United States which, pursuant to § 1.882–2, is treated as effectively connected for the

taxable year with the conduct of a trade or business in the United States.

(c) *Meaning of terms*. For the meaning of the term ''engaged in trade or business within the United States'', as used in section 881 and this section, see section 864(b) and the regulations thereunder. For determining when income, gain, or loss of a foreign corporation for a taxable year is effectively connected for that year with the conduct of a trade or business in the United States, see section 864(c), the regulations thereunder, and §1.882–2. The term *foreign corporation* has the meaning assigned to it by section 7701(a)(3) and (5) and the regulations thereunder. However, for special rules relating to possessions of the United States, see §1.881–5.

(d) *Rules applicable to foreign insurance companies*—(1) *Corporations qualifying under subchapter L*. A foreign corporation carrying on an insurance business in the United States at any time during the taxable year, which, without taking into account its income not effectively connected for the taxable year with the conduct of a trade or business in the United States, would qualify for the taxable year under part I, II, or III of subchapter L if it were a domestic corporation, shall be taxable for such year under that part on its entire taxable income (whether derived from sources within or without the United States) which is, or which pursuant to section 882 (d) or (e) and §1.882–2 is treated as, effectively connected for the taxable year with the conduct of a trade or business (whether or not its insurance business) in the United States. Any income derived by that foreign corporation from sources within the United States which is not effectively connected for the taxable year with the conduct of a trade or business in the United States is taxable as provided in section 881(a) and §1.882–1. See sections 842 and 861 through 864, and the regulations thereunder.

(2) *Corporations not qualifying under subchapter L*. A foreign corporation which carries on an insurance business in the United States at any time during the taxable year, and which, without taking into account its income not effectively connected for the taxable year with the conduct of a trade or business in the United States, would not qualify for the taxable year under part I, II, or III of subchapter L if it were a domestic corporation, and a foreign insurance company which does not carry on an insurance business in the United States at any time during the taxable year, shall be taxable—

(i) Under section 881(a) and §1.881–2 or §1.882–1 on its income from sources within the United States which is not effectively connected for the taxable year with the conduct of a trade or business in the United States,

(ii) Under section 882(a)(1) and §1.882–1 on its income (whether derived from sources within or without the United States) which is effectively connected for the taxable year with the conduct of a trade or business in the United States, and

(iii) Under section 882(a)(1) and §1.882–1 on its income from sources within the United States which pursuant to section 882 (d) or (e) and §1.882–2, is treated as effectively connected for the taxable year with the conduct of a trade or business in the United States.

(e) *Other provisions applicable to foreign corporations*—(1) *Accumulated earnings tax*. For the imposition of the accumulated earnings tax upon the accumulated taxable income of a foreign corporation formed or availed of for tax avoidance purposes, whether or not such corporation is engaged in trade or business in the United States, see section 532 and the regulations thereunder.

(2) *Personal holding company tax*. For the imposition of the personal holding company tax upon the undistributed personal holding company income of a foreign corporation which is a personal holding company, whether or not such corporation is engaged in trade or business in the United States, see sections 541 through 547, and the regulations thereunder. Except in the case of a foreign corporation having personal service contract income to which section 543(a)(7) applies, a foreign corporation is not a personal holding company if all of its stock outstanding during the last half of the taxable year is owned by nonresident alien individuals, whether directly or indirectly through foreign

estates, foreign trusts, foreign partnerships, or other foreign corporations. See section 542(c)(7).

(3) *Foreign personal holding companies.* For the mandatory inclusion in the gross income of the United States shareholders of the undistributed foreign personal holding company income of a foreign personal holding company, see section 551 and the regulations thereunder.

(4) *Controlled foreign corporations*—(i) *Subpart F income and increase of earnings invested in U.S. Property.* For the mandatory inclusion in the gross income of the U.S. shareholders of the subpart F income, of the previously excluded subpart F income withdrawn from investment in less developed countries, of the previously excluded subpart F income withdrawn from investment in foreign base company shipping operations, and of the increase in earnings invested in U.S. property, of a controlled foreign corporation, see sections 951 through 964, and the regulations thereunder.

(ii) *Certain accumulations of earnings and profits.* For the inclusion in the gross income of U.S. persons as a dividend of the gain recognized on certain sales or exchanges of stock in a foreign corporation, to the extent of certain earnings and profits attributable to the stock which were accumulated while the corporation was a controlled foreign corporation, see section 1248 and the regulations thereunder.

(5) *Changes in tax rate.* For provisions respecting the effect of any change in rate of tax during the taxable year on the income of a foreign corporation, see section 21 and the regulations thereunder.

(6) *Consolidated returns.* Except in the case of certain corporations organized under the laws of Canada or Mexico and maintained solely for the purpose of complying with the laws of that country as to title and operation of property, a foreign corporation is not an includible corporation for purposes of the privilege of making a consolidated return by an affiliated group of corporations. See section 1504 and the regulations thereunder.

(7) *Adjustment of tax of certain foreign corporations.* For the application of pre-1967 income tax provisions to corporations of a foreign country which imposes a more burdensome income tax than the United States, and for the adjustment of the income tax of a corporation of a foreign country which imposes a discriminatory income tax on the income of citizens of the United States or domestic corporations, see section 896.

(f) *Effective/applicability date.* This section applies for taxable years beginning after December 31, 1966. For corresponding rules applicable to taxable years beginning before January 1, 1967, see 26 CFR 1.881–1 (Revised as of January 1, 1971).

(Secs. 7805 (68A Stat. 917; 26 U.S.C. 7805) and 7654(e) (86 Stat. 1496; 26 U.S.C. 7654(e)) of the Internal Revenue Code of 1954)

[T.D. 7293, 38 FR 32795, Nov. 28, 1973, as amended by T.D. 7385, 40 FR 50260, Oct. 29, 1975; T.D. 7893, 48 FR 22507, May 19, 1983; T.D. 9194, 70 FR 18929, Apr. 11, 2005; T.D. 9391, 73 FR 19359, Apr. 9, 2008]

§ 1.881–2 Taxation of foreign corporations not engaged in U.S. business.

(a) *Imposition of tax.* (1) This section applies for purposes of determining the tax of a foreign corporation which at no time during the taxable year is engaged in trade or business in the United States. However, see also § 1.882–2 where such corporation has an election in effect for the taxable year in respect to real property income or receives interest on obligations of the United States. Except as otherwise provided in § 1.871–12, a foreign corporation to which this section applies is not subject to the tax imposed by section 11 or section 1201(a) but, pursuant to the provisions of section 881(a), is liable to a flat tax of 30 percent upon the aggregate of the amounts determined under paragraphs (b) and (c) of this section which are received during the taxable year from sources within the United States. Except as specifically provided in such paragraphs, such amounts do not include gains from the sale or exchange of property. To determine the source of such amounts, see sections 861 through 863, and the regulations thereunder.

(2) The tax of 30 percent is imposed by section 881(a) upon an amount only to the extent the amount constitutes gross income.

(3) Deductions shall not be allowed in determining the amount subject to tax under this section.

(4) Except as provided in § 1.882–2, a foreign corporation which at no time during the taxable year is engaged in trade or business in the United States has no income, gain, or loss for the taxable year which is effectively connected for the taxable year with the conduct of a trade or business in the United States. See section 864(c)(1)(B) and § 1.864–3.

(5) Gains and losses which, by reason of section 882(d) and § 1.882–2, are treated as gains or losses which are effectively connected for the taxable year with the conduct of a trade or business in the United States by such a foreign corporation shall not be taken into account in determining the tax under this section. See, for example, paragraph (c)(2) of § 1.871–10.

(6) Interest received by a foreign corporation pursuant to certain portfolio debt instruments is not subject to the flat tax of 30 percent described in paragraph (a)(1) of this section. For rules applicable to a foreign corporation's receipt of interest on certain portfolio debt instruments, see sections 871(h), 881(c), and § 1.871–14.

(b) *Fixed or determinable annual or periodical income*—(1) General rule. The tax of 30 percent imposed by section 881(a) applies to the gross amount received from sources within the United States as fixed or determinable annual or periodical gains, profits, or income. Specific items of fixed or determinable annual or periodical income are enumerated in section 881(a)(1) as interest, dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, and emoluments, but other items of fixed or determinable annual or periodical gains, profits, or income are also subject to the tax as, for instance, royalties, including royalties for the use of patents, copyrights, secret processes and formulas, and other like property. As to the determination of fixed or determinable annual or periodical income, see paragraph (a) of § 1.1441–2. For special rules treating gain on the disposition of section 306 stock as fixed or determinable annual or periodical income for purposes of section 881(a), see section 306(f) and paragraph (h) of § 1.306–3.

(2) *Substitute payments*. For purposes of this section, a substitute interest payment (as defined in § 1.861–2(a)(7)) received by a foreign person pursuant to a securities lending transaction or a sale-repurchase transaction (as defined in § 1.861–2(a)(7)) shall have the same character as interest income received pursuant to the terms of the transferred security. Similarly, for purposes of this section, a substitute dividend payment (as defined in § 1.861–3(a)(6)) received by a foreign person pursuant to a securities lending transaction or a sale-repurchase transaction (as defined in § 1.861–2(a)(7)) shall have the same character as a distribution received with respect to the transferred security. Where, pursuant to a securities lending transaction or a sale-repurchase transaction, a foreign person transfers to another person a security in the interest on which would qualify as portfolio interest under section 881(c) in the hands of the lender, substitute interest payments made with respect to the transferred security will be treated as portfolio interest, provided that in the case of interest on an obligation in registered form (as defined in § 1.871–14(c)(1)(i)), the transferor complies with the documentation requirement described in § 1.871–14(c)(1)(ii)(C) with respect to the payment of substitute interest and none of the exceptions to the portfolio interest exemption in sections 881(c) (3) and (4) apply. See also §§ 1.871–7(b)(2) and 1.894–1(c).

(3) *Dividend Equivalents*. For rules applicable to a foreign corporation's receipt of a dividend equivalent, see section 871(m) and the regulations thereunder.

(c) *Other income and gains*—(1) *Items subject to tax*. The tax of 30 percent imposed by section 881(a) also applies to the following gains received during the taxable year from sources within the United States:

(i) Gains described in section 631 (b) or (c), relating to the treatment of gain on the disposal of timber, coal, or iron ore with a retained economic interest;

(ii) [Reserved]

(iii) Gains from the sale or exchange after October 4, 1966, of patents, copyrights, secret processes and formulas, goodwill, trademarks, trade brands, franchises, or other like property, or of any interest in any such property, to the extent the gains are from payments (whether in a lump sum or in installments) which are contingent on the productivity, use, or disposition of the property or interest sold or exchanged, or from payments which are treated under section 871(e) and § 1.871–11 as being so contingent.

(2) *Determination of amount of gain.* The tax of 30 percent imposed upon the gains described in subparagraph (1) of this paragraph applies to the full amount of the gains and is determined (i) without regard to the alternative tax imposed by section 1201(a) upon the excess of net long-term capital gain over the net short-term capital loss; (ii) without regard to section 1231, relating to property used in the trade or business and involuntary conversions; and (iii) except in the case of gains described in subparagraph (1)(ii) of this paragraph, whether or not the gains are considered to be gains from the sale or exchange of property which is a capital asset.

(d) *Credits against tax.* The credits allowed by section 32 (relating to tax withheld at source on foreign corporations), by section 39 (relating to certain uses of gasoline and lubricating oil), and by section 6402 (relating to overpayments of tax) shall be allowed against the tax of a foreign corporation determined in accordance with this section.

(e) *Effective/applicability date.* Except as otherwise provided in this paragraph, this section applies for taxable years beginning after December 31, 1966. Paragraph (b)(2) of this section is applicable to payments made after November 13, 1997. For corresponding rules applicable to taxable years beginning before January 1, 1967, see 26 CFR 1.881–2 (Revised as of January 1, 1971). Paragraph (b)(3) of this section applies to payments made on or after January 23, 2012.

[T.D. 7293, 38 FR 32796, Nov. 28, 1973, as amended by T.D. 8735, 62 FR 53502, Oct. 14, 1997; T.D. 9323, 72 FR 18388, Apr. 12, 2007; T.D. 9572, 77 FR 3109, Jan. 23, 2012; T.D. 9648, 78 FR 73080, Dec. 5, 2013]

§ 1.881–3 Conduit financing arrangements.

(a) *General rules and definitions*—(1) *Purpose and scope.* Pursuant to the authority of section 7701(l), this section provides rules that permit the director of field operations to disregard, for purposes of section 881, the participation of one or more intermediate entities in a financing arrangement where such entities are acting as conduit entities. For purposes of this section, any reference to tax imposed under section 881 includes, except as otherwise provided and as the context may require, a reference to tax imposed under sections 871 or 884(f)(1)(A) or required to be withheld under section 1441 or 1442. See § 1.881–4 for recordkeeping requirements concerning financing arrangements. See §§ 1.1441–3(g) and 1.1441–7(f) for withholding rules applicable to conduit financing arrangements.

(2) *Definitions.* The following definitions apply for purposes of this section and §§ 1.881–4, 1.1441–3(g) and 1.1441–7(f).

(i) *Financing arrangement*—(A) *In general.* Financing arrangement means a series of transactions by which one person (the financing entity) advances money or other property, or grants rights to use property, and another person (the financed entity) receives money or other property, or rights to use property, if the advance and receipt are effected through one or more other persons (intermediate entities) and, except in cases to which paragraph (a)(2)(i)(B) of this section applies, there are financing transactions linking the financing entity, each of the intermediate entities, and the financed entity. A transfer of money or other property in satisfaction of a repayment obligation is not an advance of money or other property. A financing arrangement exists regardless of the order in which the transactions are entered into, but only for the period during which all of the financing transactions coexist. See *Examples 1, 2, 3* and *4* of

paragraph (e) of this section for illustrations of the term financing arrangement.

(B) *Special rule for related parties.* If two (or more) financing transactions involving two (or more) related persons would form part of a financing arrangement but for the absence of a financing transaction between the related persons, the director of field operations may treat the related persons as a single intermediate entity if he determines that one of the principal purposes for the structure of the financing transactions is to prevent the characterization of such arrangement as a financing arrangement. This determination shall be based upon all of the facts and circumstances, including, without limitation, the factors set forth in paragraph (b)(2) of this section. See *Examples 5* and *6* of paragraph (e) of this section for illustrations of this paragraph (a)(2)(i)(B).

(C) *Treatment of disregarded entities.* For purposes of this section, the term person includes a business entity that is disregarded as an entity separate from its single member owner under § 301.7701–1 through § 301.7701–3.

(ii) *Financing transaction*—(A) *In general.* Financing transaction means—

(*1*) Debt;

(*2*) Stock in a corporation (or a similar interest in a partnership, trust, or other person) that meets the requirements of paragraph (a)(2)(ii)(B) of this section;

(*3*) Any lease or license; or

(*4*) Any other transaction (including an interest in a trust described in sections 671 through 679) pursuant to which a person makes an advance of money or other property or grants rights to use property to a transferee who is obligated to repay or return a substantial portion of the money or other property advanced, or the equivalent in value. This paragraph (a)(2)(ii)(A)(*4*) shall not apply to the posting of collateral unless the collateral consists of cash or the person holding the collateral is permitted to reduce the collateral to cash (through a transfer, grant of a security interest or similar transaction) prior to default on the financing transaction secured by the collateral.

(B) *Limitation on inclusion of stock or similar interests*—(*1*) *In general.* Stock in a corporation (or a similar interest in a partnership, trust, or other person) will constitute a financing transaction only if one of the following conditions is satisfied—

(*i*) The issuer is required to redeem the stock or similar interest at a specified time or the holder has the right to require the issuer to redeem the stock or similar interest or to make any other payment with respect to the stock or similar interest;

(*ii*) The issuer has the right to redeem the stock or similar interest, but only if, based on all of the facts and circumstances as of the issue date, redemption pursuant to that right is more likely than not to occur; or

(*iii*) The owner of the stock or similar interest has the right to require a person related to the issuer (or any other person who is acting pursuant to a plan or arrangement with the issuer) to acquire the stock or similar interest or make a payment with respect to the stock or similar interest.

(*2*) *Rules of special application*—(*i*) *Existence of a right.* For purposes of this paragraph (a)(2)(ii)(B), a person will be considered to have a right to cause a redemption or payment if the person has the right (other than rights arising, in the ordinary course, between the date that a payment is declared and the date that a payment is made) to enforce the payment through a legal proceeding or to cause the issuer to be liquidated if it fails to redeem the interest or to make a payment. A person will not be considered to have a right to force a redemption or a payment if the right is derived solely from ownership of a controlling interest in the issuer in cases where the control does not arise from a default or similar contingency under the instrument. The person is considered to have such a right if the person has the right as of the issue date or, as of the issue date, it is more likely than not that the person will receive such a right, whether through the occurrence of a contingency or otherwise.

(*ii*) *Restrictions on payment.* The fact that the issuer does not have the legally available funds to redeem the stock or similar interest, or that the

payments are to be made in a blocked currency, will not affect the determinations made pursuant to this paragraph (a)(2)(ii)(B).

(*iii*) *Conduit entity* means an intermediate entity whose participation in the financing arrangement may be disregarded in whole or in part pursuant to this section, whether or not the director of field operations has made a determination that the intermediate entity should be disregarded under paragraph (a)(3)(i) of this section.

(*iv*) *Conduit financing arrangement* means a financing arrangement that is effected through one or more conduit entities.

(*v*) *Related* means related within the meaning of sections 267(b) or 707(b)(1), or controlled within the meaning of section 482, and the regulations under those sections. For purposes of determining whether a person is related to another person, the constructive ownership rules of section 318 shall apply, and the attribution rules of section 267(c) also shall apply to the extent they attribute ownership to persons to whom section 318 does not attribute ownership.

(3) *Disregard of participation of conduit entity*—(i) *Authority of director of field operations*. The director of field operations may determine that the participation of a conduit entity in a conduit financing arrangement should be disregarded for purposes of section 881. For this purpose, an intermediate entity will constitute a conduit entity if it meets the standards of paragraph (a)(4) of this section. The director of field operations has discretion to determine the manner in which the standards of paragraph (a)(4) of this section apply, including the financing transactions and parties composing the financing arrangement.

(ii) *Effect of disregarding conduit entity*—(A) *In general*. If the director of field operations determines that the participation of a conduit entity in a financing arrangement should be disregarded, the financing arrangement is recharacterized as a transaction directly between the remaining parties to the financing arrangement (in most cases, the financed entity and the financing entity) for purposes of section 881. To the extent that a disregarded conduit entity actually receives or makes payments pursuant to a conduit financing arrangement, it is treated as an agent of the financing entity. Except as otherwise provided, the recharacterization of the conduit financing arrangement also applies for purposes of sections 871, 884(f)(1)(A), 1441, and 1442 and other procedural provisions relating to those sections. This recharacterization will not otherwise affect a taxpayer's Federal income tax liability under any substantive provisions of the Internal Revenue Code. Thus, for example, the recharacterization generally applies for purposes of section 1461, in order to impose liability on a withholding agent who fails to withhold as required under § 1.1441–3(g), but not for purposes of § 1.882–5.

(B) *Character of payments made by the financed entity*. If the participation of a conduit financing arrangement is disregarded under this paragraph (a)(3), payments made by the financed entity generally shall be characterized by reference to the character (e.g., interest or rent) of the payments made to the financing entity. However, if the financing transaction to which the financing entity is a party is a transaction described in paragraph (a)(2)(ii)(A)(*2*) or (*4*) of this section that gives rise to payments that would not be deductible if paid by the financed entity, the character of the payments made by the financed entity will not be affected by the disregard of the participation of a conduit entity. The characterization provided by this paragraph (a)(3)(ii)(B) does not, however, extend to qualification of a payment for any exemption from withholding tax under the Internal Revenue Code or a provision of any applicable tax treaty if such qualification depends on the terms of, or other similar facts or circumstances relating to, the financing transaction to which the financing entity is a party that do not apply to the financing transaction to which the financed entity is a party. Thus, for example, payments made by a financed entity that is not a bank cannot qualify for the exemption provided by section 881(i) of the Code even if the loan between the financing entity and the conduit entity is a bank deposit.

(C) *Effect of income tax treaties.* Where the participation of a conduit entity in a conduit financing arrangement is disregarded pursuant to this section, it is disregarded for all purposes of section 881, including for purposes of applying any relevant income tax treaties. Accordingly, the conduit entity may not claim the benefits of a tax treaty between its country of residence and the United States to reduce the amount of tax due under section 881 with respect to payments made pursuant to the conduit financing arrangement. The financing entity may, however, claim the benefits of any income tax treaty under which it is entitled to benefits in order to reduce the rate of tax on payments made pursuant to the conduit financing arrangement that are recharacterized in accordance with paragraph (a)(3)(ii)(B) of this section.

(D) *Effect on withholding tax.* For the effect of recharacterization on withholding obligations, see §§ 1.1441–3(g) and 1.1441–7(f).

(E) *Special rule for a financing entity that is unrelated to both intermediate entity and financed entity—(1) Liability of financing entity.* Notwithstanding the fact that a financing arrangement is a conduit financing arrangement, a financing entity that is unrelated to the financed entity and the conduit entity (or entities) shall not itself be liable for tax under section 881 unless the financing entity knows or has reason to know that the financing arrangement is a conduit financing arrangement. But see § 1.1441–3(g) for the withholding agent's withholding obligations.

(*2*) *Financing entity's knowledge*—(*i*) *In general.* A financing entity knows or has reason to know that the financing arrangement is a conduit financing arrangement only if the financing entity knows or has reason to know of facts sufficient to establish that the financing arrangement is a conduit financing arrangement, including facts sufficient to establish that the participation of the intermediate entity in the financing arrangement is pursuant to a tax avoidance plan. A person that knows only of the financing transactions that comprise the financing arrangement will not be considered to know or have reason to know of facts sufficient to establish that the financing arrangement is a conduit financing arrangement.

(*ii*) *Presumption regarding financing entity's knowledge.* It shall be presumed that the financing entity does not know or have reason to know that the financing arrangement is a conduit financing arrangement if the financing entity is unrelated to all other parties to the financing arrangement and the financing entity establishes that the intermediate entity who is a party to the financing transaction with the financing entity is actively engaged in a substantial trade or business. An intermediate entity will not be considered to be engaged in a trade or business if its business is making or managing investments, unless the intermediate entity is actively engaged in a banking, insurance, financing or similar trade or business and such business consists predominantly of transactions with customers who are not related persons. An intermediate entity's trade or business is substantial if it is reasonable for the financing entity to expect that the intermediate entity will be able to make payments under the financing transaction out of the cash flow of that trade or business. This presumption may be rebutted if the director of field operations establishes that the financing entity knew or had reason to know that the financing arrangement is a conduit financing arrangement. See *Example 7* of paragraph (e) of this section for an illustration of the rules of this paragraph (a)(3)(ii)(E).

(iii) *Limitation on taxpayer's use of this section.* A taxpayer may not apply this section to reduce the amount of its Federal income tax liability by disregarding the form of its financing transactions for Federal income tax purposes or by compelling the director of field operations to do so. See, however, paragraph (b)(2)(i) of this section for rules regarding the taxpayer's ability to show that the participation of one or more intermediate entities results in no significant reduction in tax.

(4) *Standard for treatment as a conduit entity*—(i) *In general.* An intermediate entity is a conduit entity with respect to a financing arrangement if—

(A) The participation of the intermediate entity (or entities) in the financing arrangement reduces the tax

imposed by section 881 (determined by comparing the aggregate tax imposed under section 881 on payments made on financing transactions making up the financing arrangement with the tax that would have been imposed under paragraph (d) of this section);

(B) The participation of the intermediate entity in the financing arrangement is pursuant to a tax avoidance plan; and

(C) Either—

(*1*) The intermediate entity is related to the financing entity or the financed entity; or

(*2*) The intermediate entity would not have participated in the financing arrangement on substantially the same terms but for the fact that the financing entity engaged in the financing transaction with the intermediate entity.

(ii) *Multiple intermediate entities*—(A) *In general*. If a financing arrangement involves multiple intermediate entities, the director of field operations will determine whether each of the intermediate entities is a conduit entity. The director of field operations will make the determination by applying the special rules for multiple intermediate entities provided in this section or, if no special rules are provided, applying principles consistent with those of paragraph (a)(4)(i) of this section to each of the intermediate entities in the financing arrangement.

(B) *Special rule for related persons*. The director of field operations may treat related intermediate entities as a single intermediate entity if he determines that one of the principal purposes for the involvement of multiple intermediate entities in the financing arrangement is to prevent the characterization of an intermediate entity as a conduit entity, to reduce the portion of a payment that is subject to withholding tax or otherwise to circumvent the provisions of this section. This determination shall be based upon all of the facts and circumstances, including, but not limited to, the factors set forth in paragraph (b)(2) of this section. If a director of field operations determines that related persons are to be treated as a single intermediate entity, financing transactions between such related parties that are part of the conduit financing arrangement shall be disregarded for purposes of applying this section. *See Examples 8* and *9* of paragraph (e) of this section for illustrations of the rules of this paragraph (a)(4)(ii).

(b) *Determination of whether participation of intermediate entity is pursuant to a tax avoidance plan*—(1) *In general*. A tax avoidance plan is a plan one of the principal purposes of which is the avoidance of tax imposed by section 881. Avoidance of the tax imposed by section 881 may be one of the principal purposes for such a plan even though it is outweighed by other purposes (taken together or separately). In this regard, the only relevant purposes are those pertaining to the participation of the intermediate entity in the financing arrangement and not those pertaining to the existence of a financing arrangement as a whole. The plan may be formal or informal, written or oral, and may involve any one or more of the parties to the financing arrangement. The plan must be in existence no later than the last date that any of the financing transactions comprising the financing arrangement is entered into. The director of field operations may infer the existence of a tax avoidance plan from the facts and circumstances. In determining whether there is a tax avoidance plan, the director of field operations will weigh all relevant evidence regarding the purposes for the intermediate entity's participation in the financing arrangement. See *Examples 12* and *13* of paragraph (e) of this section for illustrations of the rule of this paragraph (b)(1).

(2) *Factors taken into account in determining the presence or absence of a tax avoidance purpose*. The factors described in paragraphs (b)(2)(i) through (iv) of this section are among the facts and circumstances taken into account in determining whether the participation of an intermediate entity in a financing arrangement has as one of its principal purposes the avoidance of tax imposed by section 881.

(i) *Significant reduction in tax*. The director of field operations will consider whether the participation of the intermediate entity (or entities) in the financing arrangement significantly reduces the tax that otherwise would

have been imposed under section 881. The fact that an intermediate entity is a resident of a country that has an income tax treaty with the United States that significantly reduces the tax that otherwise would have been imposed under section 881 is not sufficient, by itself, to establish the existence of a tax avoidance plan. The determination of whether the participation of an intermediate entity significantly reduces the tax generally is made by comparing the aggregate tax imposed under section 881 on payments made on financing transactions making up the financing arrangement with the tax that would be imposed under paragraph (d) of this section. However, the taxpayer is not barred from presenting evidence that the financing entity, as determined by the director of field operations, was itself an intermediate entity and another entity should be treated as the financing entity for purposes of applying this test. A reduction in the absolute amount of tax may be significant even if the reduction in rate is not. A reduction in the amount of tax may be significant if the reduction is large in absolute terms or in relative terms. See *Examples 14*, *15* and *16* of paragraph (e) of this section for illustrations of this factor.

(ii) *Ability to make the advance*. The director of field operations will consider whether the intermediate entity had sufficient available money or other property of its own to have made the advance to the financed entity without the advance of money or other property to it by the financing entity (or in the case of multiple intermediate entities, whether each of the intermediate entities had sufficient available money or other property of its own to have made the advance to either the financed entity or another intermediate entity without the advance of money or other property to it by either the financing entity or another intermediate entity).

(iii) *Time period between financing transactions*. The director of field operations will consider the length of the period of time that separates the advances of money or other property, or the grants of rights to use property, by the financing entity to the intermediate entity (in the case of multiple intermediate entities, from one intermediate entity to another), and ultimately by the intermediate entity to the financed entity. A short period of time is evidence of the existence of a tax avoidance plan while a long period of time is evidence that there is not a tax avoidance plan. See *Example 17* of paragraph (e) of this section for an illustration of this factor.

(iv) *Financing transactions in the ordinary course of business*. If the parties to the financing transaction are related, the director of field operations will consider whether the financing transaction occurs in the ordinary course of the active conduct of complementary or integrated trades or businesses engaged in by these entities. The fact that a financing transaction is described in this paragraph (b)(2)(iv) is evidence that the participation of the parties to that transaction in the financing arrangement is not pursuant to a tax avoidance plan. A loan will not be considered to occur in the ordinary course of the active conduct of complementary or integrated trades or businesses unless the loan is a trade receivable or the parties to the transaction are actively engaged in a banking, insurance, financing or similar trade or business and such business consists predominantly of transactions with customers who are not related persons. See *Example 18* of paragraph (e) of this section for an illustration of this factor.

(3) *Presumption if significant financing activities performed by a related intermediate entity*—(i) *General rule*. It shall be presumed that the participation of an intermediate entity (or entities) in a financing arrangement is not pursuant to a tax avoidance plan if the intermediate entity is related to either or both the financing entity or the financed entity and the intermediate entity performs significant financing activities with respect to the financing transactions forming part of the financing arrangement to which it is a party. This presumption may be rebutted if the director of field operations establishes that the participation of the intermediate entity in the financing arrangement is pursuant to a tax avoidance plan. See *Examples 22*, *23* and

24 of paragraph (e) of this section for illustrations of this presumption.

(ii) *Significant financing activities.* For purposes of this paragraph (b)(3), an intermediate entity performs significant financing activities with respect to such financing transactions only if the financing transactions satisfy the requirements of either paragraph (b)(3)(ii)(A) or (B) of this section.

(A) *Active rents or royalties.* An intermediate entity performs significant financing activities with respect to leases or licenses if rents or royalties earned with respect to such leases or licenses are derived in the active conduct of a trade or business within the meaning of section 954(c)(2)(A), to be applied by substituting the term *intermediate* entity for the term *controlled foreign corporation.*

(B) *Active risk management—(1) In general.* An intermediate entity is considered to perform significant financing activities with respect to financing transactions only if officers and employees of the intermediate entity participate actively and materially in arranging the intermediate entity's participation in such financing transactions (other than financing transactions described in paragraph (b)(3)(ii)(*B*)(*3*) of this section) and perform the business activity and risk management activities described in paragraph (b)(3)(ii)(*B*)(*2*) of this section with respect to such financing transactions, and the participation of the intermediate entity in the financing transactions produces (or reasonably can be expected to produce) efficiency savings by reducing transaction costs and overhead and other fixed costs.

(*2*) *Business activity and risk management requirements.* An intermediate entity will be considered to perform significant financing activities only if, within the country in which the intermediate entity is organized (or, if different, within the country with respect to which the intermediate entity is claiming the benefits of a tax treaty), its officers and employees—

(*i*) Exercise management over, and actively conduct, the day-to-day operations of the intermediate entity. Such operations must consist of a substantial trade or business or the supervision, administration and financing for a substantial group of related persons; and

(*ii*) Actively manage, on an ongoing basis, material market risks arising from such financing transactions as an integral part of the management of the intermediate entity's financial and capital requirements (including management of risks of currency and interest rate fluctuations) and management of the intermediate entity's short-term investments of working capital by entering into transactions with unrelated persons.

(*3*) *Special rule for trade receivables and payables entered into in the ordinary course of business.* If the activities of the intermediate entity consist in whole or in part of cash management for a controlled group of which the intermediate entity is a member, then employees of the intermediate entity need not have participated in arranging any such financing transactions that arise in the ordinary course of a substantial trade or business of either the financed entity or the financing entity. Officers or employees of the financing entity or financed entity, however, must have participated actively and materially in arranging the transaction that gave rise to the trade receivable or trade payable. Cash management includes the operation of a sweep account whereby the intermediate entity nets intercompany trade payables and receivables arising from transactions among the other members of the controlled group and between members of the controlled group and unrelated persons.

(*4*) *Activities of officers and employees of related persons.* Except as provided in paragraph (b)(3)(ii)(B)(*3*) of this section, in applying this paragraph (b)(3)(ii)(B), the activities of an officer or employee of an intermediate entity will not constitute significant financing activities if any officer or employee of a related person participated materially in any of the activities described in this paragraph, other than to approve any guarantee of a financing transaction or to exercise general supervision and control over the policies of the intermediate entity.

(c) *Determination of whether an unrelated intermediate entity would not have participated in financing arrangement on*

substantially the same terms—(1) *In general.* The determination of whether an intermediate entity would not have participated in a financing arrangement on substantially the same terms but for the financing transaction between the financing entity and the intermediate entity shall be based upon all of the facts and circumstances.

(2) *Effect of guarantee*—(i) *In general.* The director of field operations may presume that the intermediate entity would not have participated in the financing arrangement on substantially the same terms if there is a guarantee of the financed entity's liability to the intermediate entity (or in the case of multiple intermediate entities, a guarantee of the intermediate entity's liability to the intermediate entity that advanced money or property, or granted rights to use other property). However, a guarantee that was neither in existence nor contemplated on the last date that any of the financing transactions comprising the financing arrangement is entered into does not give rise to this presumption. A taxpayer may rebut this presumption by producing clear and convincing evidence that the intermediate entity would have participated in the financing transaction with the financed entity on substantially the same terms even if the financing entity had not entered into a financing transaction with the intermediate entity.

(ii) *Definition of guarantee.* For the purposes of this paragraph (c)(2), a guarantee is any arrangement under which a person, directly or indirectly, assures, on a conditional or unconditional basis, the payment of another person's obligation with respect to a financing transaction. The term shall be interpreted in accordance with the definition of the term in section 163(j)(6)(D)(iii).

(d) *Determination of amount of tax liability*—(1) *Amount of payment subject to recharacterization*—(i) *In general.* If a financing arrangement is a conduit financing arrangement, a portion of each payment made by the financed entity with respect to the financing transactions that comprise the conduit financing arrangement shall be recharacterized as a transaction directly between the financed entity and the financing entity. If the aggregate principal amount of the financing transaction(s) to which the financed entity is a party is less than or equal to the aggregate principal amount of the financing transaction(s) linking any of the parties to the financing arrangement, the entire amount of the payment shall be so recharacterized. If the aggregate principal amount of the financing transaction(s) to which the financed entity is a party is greater than the aggregate principal amount of the financing transaction(s) linking any of the parties to the financing arrangement, then the recharacterized portion shall be determined by multiplying the payment by a fraction the numerator of which is equal to the lowest aggregate principal amount of the financing transaction(s) linking any of the parties to the financing arrangement (other than financing transactions that are disregarded pursuant to paragraphs (a)(2)(i)(B) and (a)(4)(ii)(B) of this section) and the denominator of which is the aggregate principal amount of the financing transaction(s) to which the financed entity is a party. In the case of financing transactions the principal amount of which is subject to adjustment, the fraction shall be determined using the average outstanding principal amounts for the period to which the payment relates. The average principal amount may be computed using any method applied consistently that reflects with reasonable accuracy the amount outstanding for the period. See *Example 25* of paragraph (e) of this section for an illustration of the calculation of the amount of tax liability.

(ii) *Determination of principal amount*—(A) *In general.* Unless otherwise provided in this paragraph (d)(1)(ii), the principal amount equals the amount of money advanced, or the fair market value of other property advanced or subject to a lease or license, in the financing transaction. In general, fair market value is calculated in U.S. dollars as of the close of business on the day on which the financing transaction is entered into. However, if the property advanced, or the right to use property granted, by the financing entity is the same as the property or rights received by the financed entity, the fair market value of the property

or right shall be determined as of the close of business on the last date that any of the financing transactions comprising the financing arrangement is entered into. In the case of fungible property, property of the same type shall be considered to be the same property. See *Example 26* of paragraph (e) for an illustration of the calculation of the principal amount in the case of financing transactions involving fungible property. The principal amount of a financing transaction shall be subject to adjustments, as set forth in this paragraph (d)(1)(ii).

(B) *Debt instruments and certain stock.* In the case of a debt instrument or of stock that is subject to the current inclusion rules of sections 305(c)(3) or (e), the principal amount generally will be equal to the issue price. However, if the fair market value on the issue date differs materially from the issue price, the fair market value of the debt instrument shall be used in lieu of the instrument's issue price. Appropriate adjustments will be made for accruals of original issue discount and repayments of principal (including accrued original issue discount).

(C) *Partnership and trust interests.* In the case of a partnership interest or an interest in a trust, the principal amount is equal to the fair market value of the money or property contributed to the partnership or trust in return for that partnership or trust interest.

(D) *Leases or licenses.* In the case of a lease or license, the principal amount is equal to the fair market value of the property subject to the lease or license on the date on which the lease or license is entered into. The principal amount shall be adjusted for depreciation or amortization, calculated on a basis that accurately reflects the anticipated decline in the value of the property over its life.

(2) *Rate of tax.* The rate at which tax is imposed under section 881 on the portion of the payment that is recharacterized pursuant to paragraph (d)(1) of this section is determined by reference to the nature of the recharacterized transaction, as determined under paragraphs (a)(3)(ii)(B) and (C) of this section.

(e) *Examples.* The following examples illustrate this section. For purposes of these examples, unless otherwise indicated, it is assumed that FP, a corporation organized in country N, owns all of the stock of FS, a corporation organized in country T, and DS, a corporation organized in the United States. Country T, but not country N, has an income tax treaty with the United States. The treaty exempts interest, rents and royalties paid by a resident of one state (the source state) to a resident of the other state from tax in the source state.

Example 1. Financing arrangement. (i) On January 1, 1996, BK, a bank organized in country T, lends $1,000,000 to DS in exchange for a note issued by DS. FP guarantees to BK that DS will satisfy its repayment obligation on the loan. There are no other transactions between FP and BK.

(ii) BK's loan to DS is a financing transaction within the meaning of paragraph (a)(2)(ii)(A)(*1*) of this section. FP's guarantee of DS's repayment obligation is not a financing transaction as described in paragraphs (a)(2)(ii)(A)(*1*) through (*4*) of this section. Therefore, these transactions do not constitute a financing arrangement as defined in paragraph (a)(2)(i) of this section.

Example 2. Financing arrangement. (i) On January 1, 1996, FP lends $1,000,000 to DS in exchange for a note issued by DS. On January 1, 1997, FP assigns the DS note to FS in exchange for a note issued by FS. After receiving notice of the assignment, DS remits payments due under its note to FS.

(ii) The DS note held by FS and the FS note held by FP are financing transactions within the meaning of paragraph (a)(2)(ii)(A)(*1*) of this section, and together constitute a financing arrangement within the meaning of paragraph (a)(2)(i) of this section.

Example 3.Participation of a disregarded intermediate entity. The facts are the same as in *Example 2*, except that FS is an entity that is disregarded as an entity separate from its owner, FP, under §301.7701–3. Under paragraph (a)(2)(i)(C) of this section, FS is a person and, therefore, may itself be an intermediate entity that is linked by financing transactions to other persons in a financing arrangement. The DS note held by FS and the FS note held by FP are financing transactions within the meaning of paragraph (a)(2)(ii) of this section, and together constitute a financing arrangement within the meaning of paragraph (a)(2)(i) of this section.

Example 4. Financing arrangement. (i) On December 1, 1994 FP creates a special purposes subsidiary, FS. On that date FP capitalizes FS with $1,000,000 in cash and

$10,000,000 in debt from BK, a Country N bank. On January 1, 1995, C, a U.S. person, purchases an automobile from DS in return for an installment note. On August 1, 1995, DS sells a number of installment notes, including C's, to FS in exchange for $10,000,000. DS continues to service the installment notes for FS.

(ii) The C installment note now held by FS (as well as all of the other installment notes now held by FS) and the FS note held by BK are financing transactions within the meaning of paragraph (a)(2)(ii)(A)(*1*) of this section, and together constitute a financing arrangement within the meaning of paragraph (a)(2)(i) of this section.

Example 5. Related persons treated as a single intermediate entity. (i) On January 1, 1996, FP deposits $1,000,000 with BK, a bank that is organized in country N and is unrelated to FP and its subsidiaries. M, a corporation also organized in country N, is wholly-owned by the sole shareholder of BK but is not a bank within the meaning of section 881(c)(3)(A). On July 1, 1996, M lends $1,000,000 to DS in exchange for a note maturing on July 1, 2006. The note is in registered form within the meaning of section 881(c)(2)(B)(i) and DS has received from M the statement required by section 881(c)(2)(B)(ii). One of the principal purposes for the absence of a financing transaction between BK and M is the avoidance of the application of this section.

(ii) The transactions described above would form a financing arrangement but for the absence of a financing transaction between BK and M. However, because one of the principal purposes for the structuring of these financing transactions is to prevent characterization of such arrangement as a financing arrangement, the director of field operations may treat the financing transactions between FP and BK, and between M and DS as a financing arrangement under paragraphs (a)(2)(i)(B) of this section. In such a case, BK and M would be considered a single intermediate entity for purposes of this section. See also paragraph (a)(4)(ii)(B) of this section for the authority to treat BK and M as a single intermediate entity.

Example 6. Related persons treated as a single intermediate entity. (i) On January 1, 1995, FP lends $10,000,000 to FS in exchange for a 10-year note that pays interest annually at a rate of 8 percent per annum. On January 2, 1995, FS contributes $10,000,000 to FS2, a wholly-owned subsidiary of FS organized in country T, in exchange for common stock of FS2. On January 1, 1996, FS2 lends $10,000,000 to DS in exchange for an 8-year note that pays interest annually at a rate of 10 percent per annum. FS is a holding company whose most significant asset is the stock of FS2. Throughout the period that the FP-FS loan is outstanding, FS causes FS2 to make distributions to FS, most of which are used to make interest and principal payments on the FP-FS loan. Without the distributions from FS2, FS would not have had the funds with which to make payments on the FP-FS loan. One of the principal purposes for the absence of a financing transaction between FS and FS2 is the avoidance of the application of this section.

(ii) The conditions of paragraph (a)(4)(i)(A) of this section would be satisfied with respect to the financing transactions between FP, FS, FS2 and DS but for the absence of a financing transaction between FS and FS2. However, because one of the principal purposes for the structuring of these financing transactions is to prevent characterization of an entity as a conduit, the director of field operations may treat the financing transactions between FP and FS, and between FS2 and DS as a financing arrangement. See paragraph (a)(4)(ii)(B) of this section. In such a case, FS and FS2 would be considered a single intermediate entity for purposes of this section. See also paragraph (a)(2)(i)(B) of this section for the authority to treat FS and FS2 as a single intermediate entity.

Example 7. Presumption with respect to unrelated financing entity. (i) FP is a corporation organized in country T that is actively engaged in a substantial manufacturing business. FP has a revolving credit facility with a syndicate of banks, none of which is related to FP and FP's subsidiaries, which provides that FP may borrow up to a maximum of $100,000,000 at a time. The revolving credit facility provides that DS and certain other subsidiaries of FP may borrow directly from the syndicate at the same interest rates as FP, but each subsidiary is required to indemnify the syndicate banks for any withholding taxes imposed on interest payments by the country in which the subsidiary is organized. BK, a bank that is organized in country N, is the agent for the syndicate. Some of the syndicate banks are organized in country N, but others are residents of country O, a country that has an income tax treaty with the United States which allows the United States to impose a tax on interest at a maximum rate of 10 percent. It is reasonable for BK and the syndicate banks to have determined that FP will be able to meet its payment obligations on a maximum principal amount of $100,000,000 out of the cash flow of its manufacturing business. At various times throughout 1995, FP borrows under the revolving credit facility until the outstanding principal amount reaches the maximum amount of $100,000,000. On December 31, 1995, FP receives $100,000,000 from a public offering of its equity. On January 1, 1996, FP pays BK $90,000,000 to reduce the outstanding principal amount under the revolving credit facility and lends $10,000,000 to DS. FP would have repaid the entire principal amount, and DS would have borrowed directly from the syndicate, but for the fact that DS did not want to incur the U.S. withholding tax that

would have applied to payments made directly by DS to the syndicate banks.

(ii) Pursuant to paragraph (a)(3)(ii)(E)(*1*) of this section, even though the financing arrangement is a conduit financing arrangement (because the financing arrangement meets the standards for recharacterization in paragraph (a)(4)(i)), BK and the other syndicate banks have no section 881 liability unless they know or have reason to know that the financing arrangement is a conduit financing arrangement. Moreover, pursuant to paragraph (a)(3)(ii)(E)(*2*)(*ii*) of this section, BK and the syndicate banks are presumed not to know that the financing arrangement is a conduit financing arrangement. The syndicate banks are unrelated to both FP and DS, and FP is actively engaged in a substantial trade or business—that is, the cash flow from FP's manufacturing business is sufficient for the banks to expect that FP will be able to make the payments required under the financing transaction. See §1.1441–3(g) for the withholding obligations of the withholding agents.

Example 8. Multiple intermediate entities—special rule for related persons. (i) On January 1, 1995, FP lends $10,000,000 to FS in exchange for a 10-year note that pays interest annually at a rate of 8 percent per annum. On January 2, 1995, FS contributes $9,900,000 to FS2, a wholly-owned subsidiary of FS organized in country T, in exchange for common stock and lends $100,000 to FS2. On January 1, 1996, FS2 lends $10,000,000 to DS in exchange for an 8-year note that pays interest annually at a rate of 10 percent per annum. FS is a holding company that has no significant assets other than the stock of FS2. Throughout the period that the FP-FS loan is outstanding, FS causes FS2 to make distributions to FS, most of which are used to make interest and principal payments on the FP-FS loan. Without the distributions from FS2, FS would not have had the funds with which to make payments on the FP-FS loan. One of the principal purposes for structuring the transactions between FS and FS2 as primarily a contribution of capital is to reduce the amount of the payment that would be recharacterized under paragraph (d) of this section.

(ii) Pursuant to paragraph (a)(4)(ii)(B) of this section, the director of field operations may treat FS and FS2 as a single intermediate entity for purposes of this section since one of the principal purposes for the participation of multiple intermediate entities is to reduce the amount of the tax liability on any recharacterized payment by inserting a financing transaction with a low principal amount.

Example 9. Multiple intermediate entities. (i) On January 1, 1995, FP deposits $1,000,000 with BK, a bank that is organized in country T and is unrelated to FP and its subsidiaries, FS and DS. On January 1, 1996, at a time when the FP-BK deposit is still outstanding, BK lends $500,000 to BK2, a bank that is wholly-owned by BK and is organized in country T. On the same date, BK2 lends $500,000 to FS. On July 1, 1996, FS lends $500,000 to DS. FP pledges its deposit with BK to BK2 in support of FS' obligation to repay the BK2 loan. FS', BK's and BK2's participation in the financing arrangement is pursuant to a tax avoidance plan.

(ii) The conditions of paragraphs (a)(4)(i)(A) and (B) of this section are satisfied because the participation of BK, BK2 and FS in the financing arrangement reduces the tax imposed by section 881, and FS', BK's and BK2's participation in the financing arrangement is pursuant to a tax avoidance plan. However, since BK and BK2 are unrelated to FP and DS, under paragraph (a)(4)(i)(C)(*2*) of this section, BK and BK2 will be treated as conduit entities only if BK and BK2 would not have participated in the financing arrangement on substantially the same terms but for the financing transaction between FP and BK.

(iii) It is presumed that BK2 would not have participated in the financing arrangement on substantially the same terms but for the BK-BK2 financing transaction because FP's pledge of an asset in support of FS' obligation to repay the BK2 loan is a guarantee within the meaning of paragraph (c)(2)(ii) of this section. If the taxpayer does not rebut this presumption by clear and convincing evidence, then BK2 will be a conduit entity.

(iv) Because BK and BK2 are related intermediate entities, the director of field operations must determine whether one of the principal purposes for the involvement of multiple intermediate entities was to prevent characterization of an entity as a conduit entity. In making this determination, the director of field operations may consider the fact that the involvement of two related intermediate entities prevents the presumption regarding guarantees from applying to BK. In the absence of evidence showing a business purpose for the involvement of both BK and BK2, the director of field operations may treat BK and BK2 as a single intermediate entity for purposes of determining whether they would have participated in the financing arrangement on substantially the same terms but for the financing transaction between FP and BK. The presumption that applies to BK2 therefore will apply to BK. If the taxpayer does not rebut this presumption by clear and convincing evidence, then BK will be a conduit entity.

Example 10. Reduction of tax. (i) On February 1, 1995, FP issues debt to the public that would satisfy the requirements of section 871(h)(2)(A) (relating to obligations that are not in registered form) if issued by a U.S. person. FP lends the proceeds of the debt offering to DS in exchange for a note.

(ii) The debt issued by FP and the DS note are financing transactions within the meaning of paragraph (a)(2)(ii)(A)(*1*) of this section and together constitute a financing arrangement within the meaning of paragraph (a)(2)(i) of this section. The holders of the FP debt are the financing entities, FP is the intermediate entity and DS is the financed entity. Because interest payments on the debt issued by FP would not have been subject to withholding tax if the debt had been issued by DS, there is no reduction in tax under paragraph (a)(4)(i)(A) of this section. Accordingly, FP is not a conduit entity.

Example 11. Reduction of tax. (i) On January 1, 1995, FP licenses to FS the rights to use a patent in the United States to manufacture product A. FS agrees to pay FP a fixed amount in royalties each year under the license. On January 1, 1996, FS sublicenses to DS the rights to use the patent in the United States. Under the sublicense, DS agrees to pay FS royalties based upon the units of product A manufactured by DS each year. Although the formula for computing the amount of royalties paid by DS to FS differs from the formula for computing the amount of royalties paid by FS to FP, each represents an arm's length rate.

(ii) Although the royalties paid by DS to FS are exempt from U.S. withholding tax, the royalty payments between FS and FP are income from U.S. sources under section 861(a)(4) subject to the 30 percent gross tax imposed by §1.881–2(b) and subject to withholding under §1.1441–2(a). Because the rate of tax imposed on royalties paid by FS to FP is the same as the rate that would have been imposed on royalties paid by DS to FP, the participation of FS in the FP-FS-DS financing arrangement does not reduce the tax imposed by section 881 within the meaning of paragraph (a)(4)(i)(A) of this section. Accordingly, FP is not a conduit entity.

Example 12. A principal purpose. (i) On January 1, 1995, FS lends $10,000,000 to DS in exchange for a 10-year note that pays interest annually at a rate of 8 percent per annum. As was intended at the time of the loan from FS to DS, on July 1, 1995, FP makes an interest-free demand loan of $10,000,000 to FS. A principal purpose for FS' participation in the FP-FS-DS financing arrangement is that FS generally coordinates the financing for all of FP's subsidiaries (although FS does not engage in significant financing activities with respect to such financing transactions). However, another principal purpose for FS' participation is to allow the parties to benefit from the lower withholding tax rate provided under the income tax treaty between country T and the United States.

(ii) The financing arrangement satisfies the tax avoidance purpose requirement of paragraph (a)(4)(i)(B) of this section because FS participated in the financing arrangement pursuant to a plan one of the principal purposes of which is to allow the parties to benefit from the country T-U.S. treaty.

Example 13. A principal purpose. (i) DX is a U.S. corporation that intends to purchase property to use in its manufacturing business. FX is a partnership organized in country N that is owned in equal parts by LC1 and LC2, leasing companies that are unrelated to DX. BK, a bank organized in country N and unrelated to DX, LC1 and LC2, lends $100,000,000 to FX to enable FX to purchase the property. On the same day, FX purchases the property and engages in a transaction with DX which is treated as a lease of the property for country N tax purposes but a loan for U.S. tax purposes. Accordingly, DX is treated as the owner of the property for U.S. tax purposes. The parties comply with the requirements of section 881(c) with respect to the debt obligation of DX to FX. FX and DX structured these transactions in this manner so that LC1 and LC2 would be entitled to accelerated depreciation deductions with respect to the property in country N and DX would be entitled to accelerated depreciation deductions in the United States. None of the parties would have participated in the transaction if the payments made by DX were subject to U.S. withholding tax.

(ii) The loan from BK to FX and from FX to DX are financing transactions and, together constitute a financing arrangement. The participation of FX in the financing arrangement reduces the tax imposed by section 881 because payments made to FX, but not BK, qualify for the portfolio interest exemption of section 881(c) because BK is a bank making an extension of credit in the ordinary course of its trade or business within the meaning of section 881(c)(3)(A). Moreover, because DX borrowed the money from FX instead of borrowing the money directly from BK to avoid the tax imposed by section 881, one of the principal purposes of the participation of FX was to avoid that tax (even though another principal purpose of the participation of FX was to allow LC1 and LC2 to take advantage of accelerated depreciation deductions in country N). Assuming that FX would not have participated in the financing arrangement on substantially the same terms but for the fact that BK loaned it $100,000,000, FX is a conduit entity and the financing arrangement is a conduit financing arrangement.

Example 14. Significant reduction of tax. (i) FS owns all of the stock of FS1, which also is a resident of country T. FS1 owns all of the stock of DS. On January 1, 1995, FP contributes $10,000,000 to the capital of FS in return for perpetual preferred stock. On July 1, 1995, FS lends $10,000,000 to FS1. On January 1, 1996, FS1 lends $10,000,000 to DS. Under the terms of the country T-U.S. income tax treaty, a country T resident is not entitled to the reduced withholding rate on interest income provided by the treaty if the resident is

entitled to specified tax benefits under country T law. Although FS1 may deduct interest paid on the loan from FS, these deductions are not pursuant to any special tax benefits provided by country T law. However, FS qualifies for one of the enumerated tax benefits pursuant to which it may deduct dividends paid with respect to the stock held by FP. Therefore, if FS had made a loan directly to DS, FS would not have been entitled to the benefits of the country T-U.S. tax treaty with respect to payments it received from DS, and such payments would have been subject to tax under section 881 at a 30 percent rate.

(ii) The FS-FS1 loan and the FS1–DS loan are financing transactions within the meaning of paragraph (a)(2)(ii)(A)(*1*) of this section and together constitute a financing arrangement within the meaning of paragraph (a)(2)(i) of this section. Pursuant to paragraph (b)(2)(i) of this section, the significant reduction in tax resulting from the participation of FS1 in the financing arrangement is evidence that the participation of FS1 in the financing arrangement is pursuant to a tax avoidance plan. However, other facts relevant to the presence of such a plan must also be taken into account.

Example 15. Significant reduction of tax. (i) FP owns 90 percent of the voting stock of FX, an unlimited liability company organized in country T. The other 10 percent of the common stock of FX is owned by FP1, a subsidiary of FP that is organized in country N. Although FX is a partnership for U.S. tax purposes, FX is entitled to the benefits of the U.S.-country T income tax treaty because FX is subject to tax in country T as a resident corporation. On January 1, 1996, FP contributes $10,000,000 to FX in exchange for an instrument denominated as preferred stock that pays a dividend of 7 percent and that must be redeemed by FX in seven years. For U.S. tax purposes, the preferred stock is a partnership interest. On July 1, 1996, FX makes a loan of $10,000,000 to DS in exchange for a 7-year note paying interest at 6 percent.

(ii) Because FX is required to redeem the partnership interest at a specified time, the partnership interest constitutes a financing transaction within the meaning of paragraph (a)(2)(ii)(A)(*2*) of this section. Moreover, because the FX-DS note is a financing transaction within the meaning of paragraph (a)(2)(ii)(A)(*1*) of this section, together the transactions constitute a financing arrangement within the meaning of (a)(2)(i) of this section. Payments of interest made directly by DS to FP and FP1 would not be eligible for the portfolio interest exemption and would not be entitled to a reduction in withholding tax pursuant to a tax treaty. Therefore, there is a significant reduction in tax resulting from the participation of FX in the financing arrangement, which is evidence that the participation of FX in the financing arrangement is pursuant to a tax avoidance plan. However, other facts relevant to the existence of such a plan must also be taken into account.

Example 16. Significant reduction of tax. (i) FP owns a 10 percent interest in the profits and capital of FX, a partnership organized in country N. The other 90 percent interest in FX is owned by G, an unrelated corporation that is organized in country T. FX is not engaged in business in the United States. On January 1, 1996, FP contributes $10,000,000 to FX in exchange for an instrument documented as perpetual subordinated debt that provides for quarterly interest payments at 9 percent per annum. Under the terms of the instrument, payments on the perpetual subordinated debt do not otherwise affect the allocation of income between the partners. FP has the right to require the liquidation of FX if FX fails to make an interest payment. For U.S. tax purposes, the perpetual subordinated debt is treated as a partnership interest in FX and the payments on the perpetual subordinated debt constitute guaranteed payments within the meaning of section 707(c). On July 1, 1996, FX makes a loan of $10,000,000 to DS in exchange for a 7-year note paying interest at 8 percent per annum.

(ii) Because FP has the effective right to force payment of the ''interest'' on the perpetual subordinated debt, the instrument constitutes a financing transaction within the meaning of paragraph (a)(2)(ii)(A)(*2*) of this section. Moreover, because the note between FX and DS is a financing transaction within the meaning of paragraph (a)(2)(ii)(A)(*1*) of this section, together the transactions are a financing arrangement within the meaning of (a)(2)(i) of this section. Without regard to this section, 90 percent of each interest payment received by FX would be treated as exempt from U.S. withholding tax because it is beneficially owned by G, while 10 percent would be subject to a 30 percent withholding tax because beneficially owned by FP. If FP held directly the note issued by DS, 100 percent of the interest payments on the note would have been subject to the 30 percent withholding tax. The significant reduction in the tax imposed by section 881 resulting from the participation of FX in the financing arrangement is evidence that the participation of FX in the financing arrangement is pursuant to a tax avoidance plan. However, other facts relevant to the presence of such a plan must also be taken into account.

Example 17. Time period between transactions. (i) On January 1, 1995, FP lends $10,000,000 to FS in exchange for a 10-year note that pays no interest annually. When the note matures, FS is obligated to pay $24,000,000 to FP. On January 1, 1996, FS lends $10,000,000 to DS in exchange for a 10-

year note that pays interest annually at a rate of 10 percent per annum.

(ii) The FS note held by FP and the DS note held by FS are financing transactions within the meaning of paragraph (a)(2)(ii)(A)(*1*) of this section and together constitute a financing arrangement within the meaning of (a)(2)(i) of this section. Pursuant to paragraph (b)(2)(iii) of this section, the short period of time (twelve months) between the loan by FP to FS and the loan by FS to DS is evidence that the participation of FS in the financing arrangement is pursuant to a tax avoidance plan. However, other facts relevant to the presence of such a plan must also be taken into account.

Example 18. Financing transactions in the ordinary course of business. (i) FP is a holding company. FS is actively engaged in country T in the business of manufacturing and selling product A. DS manufactures product B, a principal component in which is product A. FS' business activity is substantial. On January 1, 1995, FP lends $100,000,000 to FS to finance FS' business operations. On January 1, 1996, FS ships $30,000,000 of product A to DS. In return, FS creates an interest-bearing account receivable on its books. FS' shipment is in the ordinary course of the active conduct of its trade or business (which is complementary to DS' trade or business.)

(ii) The loan from FP to FS and the accounts receivable opened by FS for a payment owed by DS are financing transactions within the meaning of paragraph (a)(2)(ii)(A)(*1*) of this section and together constitute a financing arrangement within the meaning of paragraph (a)(2)(i) of this section. Pursuant to paragraph (b)(2)(iv) of this section, the fact that DS' liability to FS is created in the ordinary course of the active conduct of DS' trade or business that is complementary to a business actively engaged in by DS is evidence that the participation of FS in the financing arrangement is not pursuant to a tax avoidance plan. However, other facts relevant to the presence of such a plan must also be taken into account.

Example 19. Tax avoidance plan—other factors. (i) On February 1, 1995, FP issues debt in Country N that is in registered form within the meaning of section 881(c)(3)(A). The FP debt would satisfy the requirements of section 881(c) if the debt were issued by a U.S. person and the withholding agent received the certification required by section 871(h)(2)(B)(ii). The purchasers of the debt are financial institutions and there is no reason to believe that they would not furnish Forms W–8. On March 1, 1995, FP lends a portion of the proceeds of the offering to DS.

(ii) The FP debt and the loan to DS are financing transactions within the meaning of paragraph (a)(2)(ii)(A)(*1*) of this section and together constitute a financing arrangement within the meaning of paragraph (a)(2)(i) of this section. The owners of the FP debt are the financing entities, FP is the intermediate entity and DS is the financed entity. Interest payments on the debt issued by FP would be subject to withholding tax if the debt were issued by DS, unless DS received all necessary Forms W–8. Therefore, the participation of FP in the financing arrangement potentially reduces the tax imposed by section 881(a). However, because it is reasonable to assume that the purchasers of the FP debt would have provided certifications in order to avoid the withholding tax imposed by section 881, there is not a tax avoidance plan. Accordingly, FP is not a conduit entity.

Example 20. Tax avoidance plan—other factors. (i) Over a period of years, FP has maintained a deposit with BK, a bank organized in the United States, that is unrelated to FP and its subsidiaries. FP often sells goods and purchases raw materials in the United States. FP opened the bank account with BK in order to facilitate this business and the amounts it maintains in the account are reasonably related to its dollar-denominated working capital needs. On January 1, 1995, BK lends $5,000,000 to DS. After the loan is made, the balance in FP's bank account remains within a range appropriate to meet FP's working capital needs.

(ii) FP's deposit with BK and BK's loan to DS are financing transactions within the meaning of paragraph (a)(2)(ii)(A)(*1*) of this section and together constitute a financing arrangement within the meaning of paragraph (a)(2)(i) of this section. Pursuant to section 881(i), interest paid by BK to FP with respect to the bank deposit is exempt from withholding tax. Interest paid directly by DS to FP would not be exempt from withholding tax under section 881(i) and therefore would be subject to a 30% withholding tax. Accordingly, there is a significant reduction in the tax imposed by section 881, which is evidence of the existence of a tax avoidance plan. See paragraph (b)(2)(i) of this section. However, the director of field operations also will consider the fact that FP historically has maintained an account with BK to meet its working capital needs and that, prior to and after BK's loan to DS, the balance within the account remains within a range appropriate to meet those business needs as evidence that the participation of BK in the FP-BK-DS financing arrangement is not pursuant to a tax avoidance plan. In determining the presence or absence of a tax avoidance plan, all relevant facts will be taken into account.

Example 21. Tax avoidance plan—other factors. (i) Assume the same facts as in *Example 20*, except that on January 1, 2000, FP's deposit with BK substantially exceeds FP's expected working capital needs and on January 2, 2000, BK lends additional funds to DS. Assume also that BK's loan to DS provides BK with a right of offset against FP's deposit. Finally, assume that FP would have lent the

funds to DS directly but for the imposition of the withholding tax on payments made directly to FP by DS.

(ii) As in *Example 19*, the transactions in paragraph (i) of this *Example 21* are a financing arrangement within the meaning of paragraph (a)(2)(i) and the participation of the BK reduces the section 881 tax. In this case, the presence of funds substantially in excess of FP's working capital needs and the fact that FP would have been willing to lend funds directly to DS if not for the withholding tax are evidence that the participation of BK in the FP-BK-FS financing arrangement is pursuant to a tax avoidance plan. However, other facts relevant to the presence of such a plan must also be taken into account. Even if the director of field operations determines that the participation of BK in the financing arrangement is pursuant to a tax avoidance plan, BK may not be treated as a conduit entity unless BK would not have participated in the financing arrangement on substantially the same terms in the absence of FP's deposit with BK. BK's right of offset against FP's deposit (a form of guarantee of BK's loan to DS) creates a presumption that BK would not have made the loan to DS on substantially the same terms in the absence of FP's deposit with BK. If the taxpayer overcomes the presumption by clear and convincing evidence, BK will not be a conduit entity.

Example 22. Significant financing activities. (i) FS is responsible for coordinating the financing of all of the subsidiaries of FP, which are engaged in substantial trades or businesses and are located in country T, country N, and the United States. FS maintains a centralized cash management accounting system for FP and its subsidiaries in which it records all intercompany payables and receivables; these payables and receivables ultimately are reduced to a single balance either due from or owing to FS and each of FP's subsidiaries. FS is responsible for disbursing or receiving any cash payments required by transactions between its affiliates and unrelated parties. FS must borrow any cash necessary to meet those external obligations and invests any excess cash for the benefit of the FP group. FS enters into interest rate and foreign exchange contracts as necessary to manage the risks arising from mismatches in incoming and outgoing cash flows. The activities of FS are intended (and reasonably can be expected) to reduce transaction costs and overhead and other fixed costs. FS has 50 employees, including clerical and other back office personnel, located in country T. At the request of DS, on January 1, 1995, FS pays a supplier $1,000,000 for materials delivered to DS and charges DS an open account receivable for this amount. On February 3, 1995, FS reverses the account receivable from DS to FS when DS delivers to FP goods with a value of $1,000,000.

(ii) The accounts payable from DS to FS and from FS to other subsidiaries of FP constitute financing transactions within the meaning of paragraph (a)(2)(ii)(A)(*1*) of this section, and the transactions together constitute a financing arrangement within the meaning of paragraph (a)(2)(i) of this section. FS's activities constitute significant financing activities with respect to the financing transactions even though FS did not actively and materially participate in arranging the financing transactions because the financing transactions consisted of trade receivables and trade payables that were ordinary and necessary to carry on the trades or businesses of DS and the other subsidiaries of FP. Accordingly, pursuant to paragraph (b)(3)(i) of this section, FS' participation in the financing arrangement is presumed not to be pursuant to a tax avoidance plan.

Example 23. Significant financing activities—active risk management. (i) The facts are the same as in Example 22, except that, in addition to its short-term funding needs, DS needs long-term financing to fund an acquisition of another U.S. company; the acquisition is scheduled to close on January 15, 1995. FS has a revolving credit agreement with a syndicate of banks located in Country N. On January 14, 1995, FS borrows ¥10 billion for 10 years under the revolving credit agreement, paying yen LIBOR plus 50 basis points on a quarterly basis. FS enters into a currency swap with BK, an unrelated bank that is not a member of the syndicate, under which FS will pay BK ¥10 billion and will receive $100 million on January 15, 1995; these payments will be reversed on January 15, 2004. FS will pay BK U.S. dollar LIBOR plus 50 basis points on a notional principal amount of $100 million semi-annually and will receive yen LIBOR plus 50 basis points on a notional principal amount of ¥10 billion quarterly. Upon the closing of the acquisition on January 15, 1995, DS borrows $100 million from FS for 10 years, paying U.S. dollar LIBOR plus 50 basis points semiannually.

(ii) Although FS performs significant financing activities with respect to certain financing transactions to which it is a party, FS does not perform significant financing activities with respect to the financing transactions between FS and the syndicate of banks and between FS and DS because FS has eliminated all material market risks arising from those financing transactions through its currency swap with BK. Accordingly, the financing arrangement does not benefit from the presumption of paragraph (b)(3)(i) of this section and the director of field operations must determine whether the participation of FS in the financing arrangement is pursuant to a tax avoidance plan on the basis of all the facts and circumstances. However, if additional facts indicated that

FS reviews its currency swaps daily to determine whether they are the most cost efficient way of managing their currency risk and, as a result, frequently terminates swaps in favor of entering into more cost efficient hedging arrangements with unrelated parties, FS would be considered to perform significant financing activities and FS' participation in the financing arrangements would not be pursuant to a tax avoidance plan.

Example 24. Significant financing activities—presumption rebutted. (i) The facts are the same as in *Example 22*, except that, on January 1, 1995, FP lends to FS DM 15,000,000 (worth $10,000,000) in exchange for a 10 year note that pays interest annually at a rate of 5 percent per annum. Also, on March 15, 1995, FS lends $10,000,000 to DS in exchange for a 10-year note that pays interest annually at a rate of 8 percent per annum. FS would not have had sufficient funds to make the loan to DS without the loan from FP. FS does not enter into any long-term hedging transaction with respect to these financing transactions, but manages the interest rate and currency risk arising from the transactions on a daily, weekly or quarterly basis by entering into forward currency contracts.

(ii) Because FS performs significant financing activities with respect to the financing transactions between FS, DS and FP, the participation of FS in the financing arrangement is presumed not to be pursuant to a tax avoidance plan. The director of field operations may rebut this presumption by establishing that the participation of FS is pursuant to a tax avoidance plan, based on all the facts and circumstances. The mere fact that FS is a resident of country T is not sufficient to establish the existence of a tax avoidance plan. However, the existence of a plan can be inferred from other factors in addition to the fact that FS is a resident of country T. For example, the loans are made within a short time period and FS would not have been able to make the loan to DS without the loan from FP.

Example 25. Determination of amount of tax liability. (i) On January 1, 1996, FP makes two three-year installment loans of $250,000 each to FS that pay interest at a rate of 9 percent per annum. The loans are self-amortizing with payments on each loan of $7,950 per month. On the same date, FS lends $1,000,000 to DS in exchange for a two-year note that pays interest semi-annually at a rate of 10 percent per annum, beginning on June 30, 1996. The FS-DS loan is not self-amortizing. Assume that for the period of January 1, 1996 through June 30, 1996, the average principal amount of the financing transactions between FP and FS that comprise the financing arrangement is $469,319. Further, assume that for the period of July 1, 1996 through December 31, 1996, the average principal amount of the financing transactions between FP and FS is $393,632. The average principal amount of the financing transaction between FS and DS for the same periods is $1,000,000. The director of field operations determines that the financing transactions between FP and FS, and FS and DS, are a conduit financing arrangement.

(ii) Pursuant to paragraph (d)(1)(i) of this section, the portion of the $50,000 interest payment made by DS to FS on June 30, 1996, that is recharacterized as a payment to FP is $23,450 computed as follows: ($50,000 × $469,319/$1,000,000) = $23,450. The portion of the interest payment made on December 31, 1996 that is recharacterized as a payment to FP is $19,650, computed as follows: ($50,000 × $393,632/$1,000,000) = $19,650. Furthermore, under §1.1441–3(g), DS is liable for withholding tax at a 30 percent rate on the portion of the $50,000 payment to FS that is recharacterized as a payment to FP, i.e., $7,035 with respect to the June 30, 1996 payment and $5,895 with respect to the December 31, 1996 payment.

Example 26. Determination of principal amount. (i) FP lends DM 5,000,000 to FS in exchange for a ten year note that pays interest semi-annually at a rate of 8 percent per annum. Six months later, pursuant to a tax avoidance plan, FS lends DM 10,000,000 to DS in exchange for a 10 year note that pays interest semi-annually at a rate of 10 percent per annum. At the time FP make its loan to FS, the exchange rate is DM 1.5/$1. At the time FS makes its loan to DS the exchange rate is DM 1.4/$1.

(ii) FP's loan to FS and FS' loan to DS are financing transactions and together constitute a financing arrangement. Furthermore, because the participation of FS reduces the tax imposed under section 881 and FS' participation is pursuant to a tax avoidance plan, the financing arrangement is a conduit financing arrangement.

(iii) Pursuant to paragraph (d)(1)(i) of this section, the amount subject to recharacterization is a fraction the numerator of which is the lowest aggregate principal amount advanced and the denominator of which is the principal amount advanced from FS to DS. Because the property advanced in these financing transactions is the same type of fungible property, under paragraph (d)(1)(ii)(A) of this section, both are valued on the date of the last financing transaction. Accordingly, the portion of the payments of interest that is recharacterized is ((DM 5,000,000 × DM 1.4/$1)/(DM 10,000,000 × DM 1.4/$1) or 0.5.

(f) *Effective/applicability date.* This section is effective for payments made by financed entities on or after September 11, 1995. This section shall not apply to interest payments covered by section 127(g)(3) of the Tax Reform Act of 1984, and to interest payments with respect to other debt obligations issued

prior to October 15, 1984 (whether or not such debt was issued by a Netherlands Antilles corporation). Paragraph (a)(2)(i)(C) and *Example 3* of paragraph (e) of this section apply to payments made on or after December 9, 2011.

[T.D. 8611, 60 FR 41005, Aug. 11, 1995; 60 FR 55312, Oct. 31, 1995; 63 FR 67578, Dec. 8, 1998; T.D. 9562, 76 FR 76896, Dec. 9, 2011; 77 FR 22480, Apr. 16, 2012]

§ 1.881–4 Recordkeeping requirements concerning conduit financing arrangements.

(a) *Scope*. This section provides rules for the maintenance of records concerning certain financing arrangements to which the provisions of § 1.881–3 apply.

(b) *Recordkeeping requirements*—(1) *In general*. Any person subject to the general recordkeeping requirements of section 6001 must keep the permanent books of account or records, as required by section 6001, that may be relevant to determining whether that person is a party to a financing arrangement and whether that financing arrangement is a conduit financing arrangement.

(2) *Application of Sections 6038 and 6038A*. A financed entity that is a reporting corporation within the meaning of section 6038A(a) and the regulations under that section, and any other person that is subject to the recordkeeping requirements of § 1.6038A–3, must comply with those recordkeeping requirements with respect to records that may be relevant to determining whether the financed entity is a party to a financing arrangement and whether that financing arrangement is a conduit financing arrangement. Such records, including records that a person is required to maintain pursuant to paragraph (c) of this section, shall be considered records that are required to be maintained pursuant to section 6038 or 6038A. Accordingly, the provisions of sections 6038 and 6038A (including, without limitation, the penalty provisions thereof), and the regulations under those sections, shall apply to any records required to be maintained pursuant to this section.

(c) *Records to be maintained*—(1) *In general*. An entity described in paragraph (b) of this section shall be required to retain any records containing the following information concerning each financing transaction that the entity knows or has reason to know comprises the financing arrangement—

(i) The nature (e.g., loan, stock, lease, license) of each financing transaction;

(ii) The name, address, taxpayer identification number (if any) and country of residence of—

(A) Each person that advanced money or other property, or granted rights to use property;

(B) Each person that was the recipient of the advance or rights; and

(C) Each person to whom a payment was made pursuant to the financing transaction (to the extent that person is a different person than the person who made the advance or granted the rights);

(iii) The date and amount of—

(A) Each advance of money or other property or grant of rights; and

(B) Each payment made in return for the advance or grant of rights;

(iv) The terms of any guarantee provided in conjunction with a financing transaction, including the name of the guarantor; and

(v) In cases where one or both of the parties to a financing transaction are related to each other or another entity in the financing arrangement, the manner in which these persons are related.

(2) *Additional documents*. An entity described in paragraph (b) of this section must also retain all records relating to the circumstances surrounding its participation in the financing transactions and financing arrangements. Such documents may include, but are not limited to—

(i) Minutes of board of directors meetings;

(ii) Board resolutions or other authorizations for the financing transactions;

(iii) Private letter rulings;

(iv) Financial reports (audited or unaudited);

(v) Notes to financial statements;

(vi) Bank statements;

(vii) Copies of wire transfers;

(viii) Offering documents;

(ix) Materials from investment advisors, bankers and tax advisors; and

(x) Evidences of indebtedness.

(3) *Effect of record maintenance requirement*. Record maintenance in accordance with paragraph (b) of this section generally does not require the original creation of records that are ordinarily not created by affected entities. If, however, a document that is actually created is described in this paragraph (c), it is to be retained even if the document is not of a type ordinarily created by the affected entity.

(d) *Effective date*. This section is effective September 11, 1995. This section shall not apply to interest payments covered by section 127(g)(3) of the Tax Reform Act of 1984, and to interest payments with respect to other debt obligations issued prior to October 15, 1984 (whether or not such debt was issued by a Netherlands Antilles corporation).

[T.D. 8611, 60 FR 41014, Aug. 11, 1995]

§ 1.881–5 Exception for certain possessions corporations.

(a) *Scope*. Section 881(b) and this section provide special rules for the application of sections 881 and 884 to certain corporations created or organized in possessions of the United States. Paragraph (g) of this section provides special rules for the application of sections 881 and 884 to corporations created or organized in the United States for purposes of determining tax liability incurred to certain possessions that administer income tax laws that are identical (except for the substitution of the name of the possession for the term ''United States'' where appropriate) to those in force in the United States. See § 1.884–0(b) for special rules relating to the application of section 884 with respect to possessions of the United States.

(b) *Operative rules*. (1) Corporations described in paragraphs (c) and (d) of this section are not treated as foreign corporations for purposes of section 881. Accordingly, they are exempt from the tax imposed by section 881(a).

(2) For corporations described in paragraph (e) of this section, the rate of tax imposed by section 881(a) on U.S. source dividends received is 10 percent (rather than the generally applicable 30 percent).

(c) *U.S. Virgin Islands and section 931 possessions*. A corporation created or organized in, or under the law of, the U.S. Virgin Islands or a section 931 possession is described in this paragraph (c) for a taxable year when the following conditions are satisfied—

(1) At all times during such taxable year, less than 25 percent in value of the stock of such corporation is beneficially owned (directly or indirectly) by foreign persons;

(2) At least 65 percent of the gross income of such corporation is shown to the satisfaction of the Commissioner upon examination to be effectively connected with the conduct of a trade or business in such a possession or the United States for the 3-year period ending with the close of the taxable year of such corporation (or for such part of such period as the corporation or any predecessor has been in existence); and

(3) No substantial part of the income of such corporation for the taxable year is used (directly or indirectly) to satisfy obligations to persons who are not bona fide residents of such a possession or the United States.

(d) *Section 935 possessions*. A corporation created or organized in, or under the law of, a section 935 possession is described in this paragraph (d) for a taxable year when the following conditions are satisfied—

(1) At all times during such taxable year, less than 25 percent in value of the stock of such corporation is owned (directly or indirectly) by foreign persons; and

(2) At least 20 percent of the gross income of such corporation is shown to the satisfaction of the Commissioner upon examination to have been derived from sources within such possession for the 3-year period ending with the close of the preceding taxable year of such corporation (or for such part of such period as the corporation has been in existence).

(e) *Puerto Rico*. A corporation created or organized in, or under the law of, Puerto Rico is described in this paragraph (e) for a taxable year when the conditions of paragraphs (c)(1) through (c)(3) of this section are satisfied (using the language ''Puerto Rico'' instead of ''such a possession'').

(f) *Definitions and other rules*. For purposes of this section—

(1) ''Section 931 possession'' is defined in § 1.931–1(c)(1);and

(2) ''Section 935 possession'' is defined in § 1.935–1(a)(3)(i).

(3) *Foreign person* means any person other than—

(i) A United States person (as defined in section 7701(a)(30) and the regulations under that section); or

(ii) A person who would be a United States person if references to the United States in section 7701 included references to a possession of the United States.

(4) *Bona fide resident*—

(i) With respect to a particular possession, means—

(A) An individual who is a bona fide resident of the possession as defined in § 1.937–1; or

(B) A business entity organized under the laws of the possession and taxable as a corporation in the possession; and

(ii) With respect to the United States, means—

(A) An individual who is a citizen or resident of the United States (as defined under section 7701(b)(1)(A)); or

(B) A business entity organized under the laws of the United States or any State that is classified as a corporation for Federal tax purposes under § 301.7701–2(b) of this chapter.

(5) *Source*. The rules of § 1.937–2 will apply for determining whether income is from sources within a possession.

(6) *Effectively connected income*. The rules of § 1.937–3 (other than paragraph (c) of that section) will apply for determining whether income is effectively connected with the conduct of a trade or business in a possession.

(7) *Indirect ownership*. The rules of section 318(a)(2) will apply except that the language ''5 percent'' will be used instead of ''50 percent'' in section 318(a)(2)(C).

(g) *Mirror code jurisdictions*. For purposes of applying mirrored section 881 to determine tax liability incurred to a section 935 possession or the U.S. Virgin Islands—

(1) The rules of paragraphs (b) through (d) of this section will not apply; and

(2) A corporation created or organized in, or under the law of, such possession or the United States will not be considered a foreign corporation.

(h) *Example*. The principles of this section are illustrated by the following example:

Example. X is a corporation organized under the law of the U.S. Virgin Islands with a branch located in State F. At least 65 percent of the gross income of X is effectively connected with the conduct of a trade or business in the U.S. Virgin Islands and no substantial part of the income of X for the taxable year is used to satisfy obligations to persons who are not bona fide residents of the United States or the U.S. Virgin Islands. Seventy-four percent of the stock of X is owned by unrelated individuals who are residents of the United States or the U.S. Virgin Islands. Y, a corporation organized under the law of State D, and Z, a partnership organized under the law of State F, each own 13 percent of the stock of X. A, an unrelated foreign individual, owns 100 percent of the stock of corporation Y. B and C, unrelated foreign individuals, each own a 50 percent interest in partnership Z. Thus, the condition of paragraph (c)(1) of this section is not satisfied, because 26 percent of X is owned indirectly by foreign persons (A, B, and C). Accordingly, X is treated as a foreign corporation for purposes of section 881.

(i) *Effective/applicability dates*. Except as otherwise provided in this paragraph (i), this section applies to payments made in taxable years ending after April 9, 2008. If, on or after April 9, 2008, there takes effect an increase in the Commonwealth of Puerto Rico's withholding tax generally applicable to dividends paid to United States corporations not engaged in a trade or business in the Commonwealth to a rate greater than 10 percent, the rules of paragraphs (b)(2) and (e) of this section will not apply to dividends received on or after the effective date of the increase. Paragraph (f)(4) of this section applies to payments made after January 31, 2006. Taxpayers may choose to apply paragraph (f)(4) of this section to payments made after October 22, 2004.

[T.D. 9248, 71 FR 5001, Jan. 31, 2006, as amended by T.D. 9391, 73 FR 19359, Apr. 9, 2008; 73 FR 27728, May 14, 2008]

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[T.D. 8658, 61 FR 9329, Mar. 8, 1996; 61 FR 15891, Apr. 10, 1996, as amended by T.D. 9281, 71 FR 47448, Aug. 17, 2006; T.D. 9465, 74 FR 49317, Sept. 28, 2009]

§ 1.882–1 Taxation of foreign corporations engaged in U.S. business or of foreign corporations treated as having effectively connected income.

(a) *Segregation of income.* This section applies for purposes of determining the tax of a foreign corporation which at any time during the taxable year is engaged in trade or business in the United States. It also applies for purposes of determining the tax of a foreign corporation which at no time during the taxable year is engaged in trade or business in the United States but has for the taxable year real property income or interest on obligations of the United States which, by reason of section 882 (d) or (e) and § 1.882–2, is treated as effectively connected for the taxable year with the conduct of a trade or business in the United States by that corporation. A foreign corporation to which this section applies must segregate its gross income for the taxable year into two categories, namely, the income which is effectively connected for the taxable year with the conduct of a trade or business in the United States by that corporation and the income which is not effectively connected for the taxable year with the conduct of a trade or business in the United States by that corporation. A separate tax shall then be determined upon each such category of income, as provided in paragraph (b) of this section. The determination of whether income or gain is or is not effectively connected for the taxable year with the conduct of a trade or business in the United States by the foreign corporation shall be made in accordance with section 864(c) and §§ 1.864–3 through 1.864–7. For purposes of this section income which is effectively connected for the taxable year with the conduct of a trade or business in the United States includes all income which is treated under section 882 (d) or (e) and § 1.882–2 as income which is effectively connected for the taxable year with the conduct of a trade or business in the United States by the foreign corporation.

(b) *Imposition of tax*—(1) *Income not effectively connected with the conduct of a trade or business in the United States.* If a foreign corporation to which this section applies derives during the taxable year from sources within the United States income or gains described in section 881(a) and paragraph (b) or (c) of § 1.881–2 which are not effectively connected for the taxable year with the conduct of a trade or business in the United States by that corporation, such income or gains shall be subject to a flat tax of 30 percent of the aggregate amount of such items. This tax shall be determined in the manner, and subject to the same conditions, set forth in § 1.881–2 as though the income or gains were derived by a foreign corporation not engaged in trade or business in the United States during the

taxable year, except that in applying paragraph (c) of such section there shall not be taken into account any gains which are taken into account in determining the tax under section 882(a)(1) and subparagraph (2) of this paragraph.

(2) *Income effectively connected with the conduct of a trade or business in the United States*—(i) *In general*. If a foreign corporation to which this section applies derives income or gains which are effectively connected for the taxable year with the conduct of a trade or business in the United States by that corporation, the taxable income or gains shall, except as provided in § 1.871–12, be taxed in accordance with section 11 or, in the alternative, section 1201(a). See sections 11(f) and 882(a)(1). Any income of the foreign corporation which is not effectively connected for the taxable year with the conduct of a trade or business in the United States by that corporation shall not be taken into account in determining either the rate or amount of such tax.

(ii) *Determination of taxable income*. The taxable income for any taxable year for purposes of this subparagraph consists only of the foreign corporation's taxable income which is effectively connected for the taxable year with the conduct of a trade or business in the United States by that corporation; and, for this purpose, it is immaterial that the trade or business with which that income is effectively connected is not the same as the trade or business carried on in the United States by that corporation during the taxable year. See example 2 in § 1.864–4(b). In determining such taxable income all amounts constituting, or considered to be, gains or losses for the taxable year from the sale or exchange of capital assets shall be taken into account if such gains or losses are effectively connected for the taxable year with the conduct of a trade or business in the United States by that corporation.

(iii) *Cross references*. For rules for determining the gross income and deductions for the taxable year, see section 882 (b) and (c)(1) and the regulations thereunder.

(c) *Change in trade or business status*. The principles of paragraph (c) of § 1.871–8 shall apply to cases where there has been a change in the trade or business status of a foreign corporation.

(d) *Credits against tax*. The credits allowed by section 32 (relating to tax withheld at source on foreign corporations), section 33 (relating to the foreign tax credit), section 38 (relating to investment in certain depreciable property), section 39 (relating to certain uses of gasoline and lubricating oil), section 40 (relating to expenses of work incentive programs), and section 6042 (relating to overpayments of a tax) shall be allowed against the tax determined in accordance with this section. However, the credits allowed by sections 33, 38, and 40 shall not be allowed against the flat tax of 30 percent imposed by section 881(a) and paragraph (b)(1) of this section. For special rules applicable in determining the foreign tax credit, see section 906(b) and the regulations thereunder. For the disallowance of certain credits where a return is not filed for the taxable year see section 882(c)(2) and the regulations thereunder.

(e) *Payment of estimated tax*. Every foreign corporation which for the taxable year is subject to tax under section 11 or 1201(a) and this section must make payment of its estimated tax in accordance with section 6154 and the regulations thereunder. In determining the amount of the estimated tax the foreign corporation must treat the tax imposed by section 881(a) and paragraph (b)(1) of this section as though it were a tax imposed by section 11.

(f) *Effective date*. This section applies for taxable years beginning after December 31, 1966. For corresponding rules applicable to taxable years beginning before January 1, 1967, see 26 CFR 1.882–1 (Revised as of January 1, 1971).

[T.D. 7293, 38 FR 32797, Nov. 28, 1973]

§ 1.882–2 Income of foreign corporations treated as effectively connected with U.S. business.

(a) *Election as to real property income*. A foreign corporation which during the taxable year derives any income from real property which is located in the United States, or derives income from

any interest in any such real property, may elect, pursuant to section 882(d) and § 1.871–10, to treat all such income as income which is effectively connected for the taxable year with the conduct of a trade or business in the United States by that corporation. The election may be made whether or not the foreign corporation is engaged in trade or business in the United States during the taxable year for which the election is made or whether or not the corporation has income from real property which for the taxable year is effectively connected with the conduct of a trade or business in the United States, but it may be made only with respect to income from sources within the United States which, without regard to section 882(d) and § 1.871–10, is not effectively connected for the taxable year with the conduct of a trade or business in the United States by that corporation. The income to which the election applies shall be determined as provided in paragraph (b) of § 1.871–10 and shall be subject to tax in the manner, and subject to the same conditions, provided by section 882(a)(1) and paragraph (b)(2) of § 1.882–1. Section 871(d) (2) and (3) and the provisions of § 1.871–10 thereunder shall apply in respect of an election under section 882(d) in the same manner and to the same extent as they apply in respect of elections under section 871(d).

(b) *Interest on U.S. obligations received by banks organized in possessions.* Interest received from sources within the United States during the taxable year on obligations of the United States by a foreign corporation created or organized in, or under the law of, a possession of the United States and carrying on the banking business in a possession of the United States during the taxable year shall be treated, pursuant to section 882(e) and this paragraph, as income which is effectively connected for the taxable year with the conduct of a trade or business in the United States by that corporation. This paragraph applies whether or not the foreign corporation is engaged in trade or business in the United States at any time during the taxable year but only with respect to income which, without regard to this paragraph, is not effectively connected for the taxable year with the conduct of a trade or business in the United States by that corporation. Any interest to which this paragraph applies shall be subject to tax in the manner, and subject to the same conditions, provided by section 882(a)(1) and paragraph (b)(2) of § 1.882–1. To the extent that deductions are connected with interest to which this paragraph applies, they shall be treated for purposes of section 882(c)(1) and the regulations thereunder as connected with income which is effectively connected for the taxable year with the conduct of a trade or business in the United States by the foreign corporation. An election by the taxpayer is not required in respect of the income to which this paragraph applies. For purposes of this paragraph the term ''possession of the United States'' includes Guam, the Midway Islands, the Panama Canal Zone, the Commonwealth of Puerto Rico, American Samoa, the Virgin Islands, and Wake Island.

(c) *Treatment of income.* Any income in respect of which an election described in paragraph (a) of this section is in effect, and any interest to which paragraph (b) of this section applies, shall be treated, for purposes of paragraph (b)(2) of § 1.882–1 and paragraph (a) of § 1.1441–4, as income which is effectively connected for the taxable year with the conduct of a trade or business in the United States by the foreign corporation. A foreign corporation shall not be treated as being engaged in trade or business in the United States merely by reason of having such income for the taxable year.

(d) *Effective date.* This section applies for taxable years beginning after December 31, 1966. There are no corresponding rules in this part for taxable years beginning before January 1, 1967.

[T.D. 7293, 38 FR 32798, Nov. 28, 1973]

§ 1.882–3 Gross income of a foreign corporation.

(a) *In general*—(1) *Inclusions.* The gross income of a foreign corporation for any taxable year includes only (i) the gross income which is derived from sources within the United States and which is not effectively connected for the taxable year with the conduct of a trade or business in the United States

by that corporation and (ii) the gross income, irrespective of whether such income is derived from sources within or without the United States, which is effectively connected for the taxable year with the conduct of a trade or business in the United States by that corporation. For the determination of the sources of income, see sections 861 through 863, and the regulations thereunder. For the determination of whether income from sources within or without the United States is effectively connected for the taxable year with the conduct of a trade or business in the United States, see sections 864(c) and 882 (d) and (e), §§ 1.864–3 through 1.864–7, and § 1.882–2.

(2) *Exchange transactions.* Even though a foreign corporation which effects certain transactions in the United States in stocks, securities, or commodities during the taxable year may not, by reason of section 864(b)(2) and paragraph (c) or (d) of § 1.864–2, be engaged in trade or business in the United States during the taxable year through the effecting of such transactions, nevertheless it shall be required to include in gross income for the taxable year the gains and profits from those transactions to the extent required by paragraph (c) of § 1.881–2 or by paragraph (a) of § 1.882–1.

(3) *Exclusions.* For exclusions from gross income of a foreign corporation, see § 1.883–1.

(b) *Foreign corporations not engaged in U.S. business.* In the case of a foreign corporation which at no time during the taxable year is engaged in trade or business in the United States the gross income shall include only (1) the gross income from sources within the United States which is described in section 881(a) and paragraphs (b) and (c) of § 1.881–2, and (2) the gross income from sources within the United States which, by reason of section 882 (d) or (e) and § 1.882–2, is treated as effectively connected for the taxable year with the conduct of a trade or business in the United States by that corporation.

(c) *Foreign corporations engaged in U.S. business.* In the case of a foreign corporation which is engaged in trade or business in the United States at any time during the taxable year, the gross income shall include (1) the gross income from sources within and without the United States which is effectively connected for the taxable year with the conduct of a trade or business in the United States by that corporation, (2) the gross income from sources within the United States which, by reason of section 882 (d) or (e) and § 1.882–2, is treated as effectively connected for the taxable year with the conduct of a trade or business in the United States by that corporation, and (3) the gross income from sources within the United States which is described in section 881(a) and paragraphs (b) and (c) of § 1.881–2 and is not effectively connected for the taxable year with the conduct of a trade or business in the United States by that corporation.

(d) *Effective date.* This section applies for taxable years beginning after December 31, 1966. For corresponding rules applicable to taxable years beginning before January 1, 1967, see 26 CFR 1.882–2 (Revised as of January 1, 1971).

[T.D. 7293, 38 FR 32799, Nov. 28, 1973]

§ 1.882–4 Allowance of deductions and credits to foreign corporations.

(a) *Foreign corporations*—(1) *In general.* A foreign corporation that is engaged in, or receives income treated as effectively connected with, a trade or business within the United States is allowed the deductions which are properly allocated and apportioned to the foreign corporation's gross income which is effectively connected, or treated as effectively connected, with its conduct of a trade or business within the United States. The foreign corporation is entitled to credits which are attributable to that effectively connected income. No provision of this section (other than paragraph (b)(2)) shall be construed to deny the credits provided by sections 33, 34 and 852(b)(3)(D)(ii) or the deduction allowed by section 170.

(2) *Return necessary.* A foreign corporation shall receive the benefit of the deductions and credits otherwise allowed to it with respect to the income tax, only if it timely files or causes to be filed with the Philadelphia Service Center, in the manner prescribed in subtitle F, a true and accurate return of its taxable income which is effectively connected, or treated as

effectively connected, for the taxable year with the conduct of a trade or business in the United States by that corporation. The deductions and credits allowed such a corporation electing under a tax convention to be subject to tax on a net basis may be obtained by filing a return of income in the manner prescribed in the regulations (if any) under the tax convention or under any other guidance issued by the Commissioner.

(3) *Filing deadline for return.* (i) As provided in paragraph (a)(2) of this section, for purposes of computing the foreign corporation's taxable income for any taxable year, otherwise allowable deductions (other than that allowed by section 170) and credits (other than those allowed by sections 33, 34 and 852(b)(3)(D)(ii)) will be allowed only if a return for that taxable year is filed by the foreign corporation on a timely basis. For taxable years of a foreign corporation ending after July 31, 1990, whether a return for the current taxable year has been filed on a timely basis is dependent upon whether the foreign corporation filed a return for the taxable year immediately preceding the current taxable year. If a return was filed for that immediately preceding taxable year, or if the current taxable year is the first taxable year of the foreign corporation for which a return is required to be filed, the required return for the current taxable year must be filed within 18 months of the due date as set forth in section 6072 and the regulations under that section, for filing the return for the current taxable year. If no return for the taxable year immediately preceding the current taxable year has been filed, the required return for the current taxable year (other than the first taxable year of the foreign corporation for which a return is required to be filed) must have been filed no later than the earlier of the date which is 18 months after the due date, as set forth in section 6072, for filing the return for the current taxable year or the date the Internal Revenue Service mails a notice to the foreign corporation advising the corporation that the current year tax return has not been filed and that no deductions (other than that allowed under section 170) or credits (other than those allowed under sections 33, 34 and 852(b)(3)(D)(ii)) may be claimed by the taxpayer.

(ii) The filing deadlines set forth in paragraph (a)(3)(i) of this section may be waived if the foreign corporation establishes to the satisfaction of the Commissioner or his or her delegate that the corporation, based on the facts and circumstances, acted reasonably and in good faith in failing to file a U.S. income tax return (including a protective return (as described in paragraph (a)(3)(vi) of this section)). For this purpose, a foreign corporation shall not be considered to have acted reasonably and in good faith if it knew that it was required to file the return and chose not to do so. In addition, a foreign corporation shall not be granted a waiver unless it cooperates in the process of determining its income tax liability for the taxable year for which the return was not filed. The Commissioner or his or her delegate shall consider the following factors in determining whether the foreign corporation, based on the facts and circumstances, acted reasonably and in good faith in failing to file a U.S. income tax return—

(A) Whether the corporation voluntarily identifies itself to the Internal Revenue Service as having failed to file a U.S. income tax return before the Internal Revenue Service discovers the failure to file;

(B) Whether the corporation did not become aware of its ability to file a protective return (as described in paragraph (a)(3)(vi) of this section) by the deadline for filing a protective return;

(C) Whether the corporation had not previously filed a U.S. income tax return;

(D) Whether the corporation failed to file a U.S. income tax return because, after exercising reasonable diligence (taking into account its relevant experience and level of sophistication), the corporation was unaware of the necessity for filing the return;

(E) Whether the corporation failed to file a U.S. income tax return because of intervening events beyond its control; and

(F) Whether other mitigating or exacerbating factors existed.

(iii) The following examples illustrate the provisions of this section. In all examples, FC is a foreign corporation and uses the calendar year as its taxable year. The examples are as follows:

Example 1. Foreign corporation discloses own failure to file. In Year 1, FC became a limited partner with a passive investment in a U.S. limited partnership that was engaged in a U.S. trade or business. During Year 1 through Year 4, FC incurred losses with respect to its U.S. partnership interest. FC's foreign tax director incorrectly concluded that because it was a limited partner and had only losses from its partnership interest, FC was not required to file a U.S. income tax return. FC's management was aware neither of FC's obligation to file a U.S. income tax return for those years, nor of its ability to file a protective return for those years. FC had never filed a U.S. income tax return before. In Year 5, FC began realizing a profit rather than a loss with respect to its partnership interest and, for this reason, engaged a U.S. tax advisor to handle its responsibility to file U.S. income tax returns. In preparing FC's income tax return for Year 5, FC's U.S. tax advisor discovered that returns were not filed for Year 1 through Year 4. Therefore, with respect to those years for which applicable filing deadlines in paragraph (a)(3)(i) of this section were not met, FC would be barred by paragraph (a)(2) of this section from claiming any deductions that otherwise would have given rise to net operating losses on returns for those years, and that would have been available as loss carryforwards in subsequent years. At FC's direction, its U.S. tax advisor promptly contacted the appropriate examining personnel and cooperated with the Internal Revenue Service in determining FC's income tax liability, for example, by preparing and filing the appropriate income tax returns for Year 1 through Year 4 and by making FC's books and records available to an Internal Revenue Service examiner. FC has met the standard described in paragraph (a)(3)(ii) of this section for waiver of any applicable filing deadlines in paragraph (a)(3)(i) of this section.

Example 2. Foreign corporation refuses to cooperate. Same facts as in *Example 1,* except that while FC's U.S. tax advisor contacted the appropriate examining personnel and filed the appropriate income tax returns for Year 1 through Year 4, FC refused all requests by the Internal Revenue Service to provide supporting information (for example, books and records) with respect to those returns. Because FC did not cooperate in determining its U.S. tax liability for the taxable years for which an income tax return was not timely filed, FC is not granted a waiver as described in paragraph (a)(3)(ii) of this section of any applicable filing deadlines in paragraph (a)(3)(i) of this section.

Example 3. Foreign corporation fails to file a protective return. Same facts as in *Example 1,* except that in Year 1 through Year 4, FC's tax director also consulted a U.S. tax advisor, who advised FC's tax director that it was uncertain whether U.S. income tax returns were necessary for those years and that FC could protect its right subsequently to claim the loss carryforwards by filing protective returns under paragraph (a)(3)(vi) of this section. FC did not file U.S. income tax returns or protective returns for those years. FC did not present evidence that intervening events beyond FC's control prevented it from filing an income tax return, and there were no other mitigating factors. FC has not met the standard described in paragraph (a)(3)(ii) of this section for waiver of any applicable filing deadlines in paragraph (a)(3)(i) of this section.

Example 4. Foreign corporation with effectively connected income. In Year 1, FC, a technology company, opened an office in the United States to market and sell a software program that FC had developed outside the United States. FC had minimal business or tax experience internationally, and no such experience in the United States. Through FC's direct efforts, U.S. sales of the software produced income effectively connected with a U.S. trade or business. FC, however, did not file U.S. income tax returns for Year 1 or Year 2. FC's management was aware neither of FC's obligation to file a U.S. income tax return for those years, nor of its ability to file a protective return for those years. FC had never filed a U.S. income tax return before. In January of Year 4, FC engaged U.S. counsel in connection with licensing software to an unrelated U.S. company. U.S. counsel reviewed FC's U.S. activities and advised FC that it should have filed U.S. income tax returns for Year 1 and Year 2. FC immediately engaged a U.S. tax advisor who, at FC's direction, promptly contacted the appropriate examining personnel and cooperated with the Internal Revenue Service in determining FC's income tax liability, for example, by preparing and filing the appropriate income tax returns for Year 1 and Year 2 and by making FC's books and records available to an Internal Revenue Service examiner. FC has met the standard described in paragraph (a)(3)(ii) of this section for waiver of any applicable filing deadlines in paragraph (a)(3)(i) of this section.

Example 5. IRS discovers foreign corporation's failure to file. In Year 1, FC, a technology company, opened an office in the United States to market and sell a software program that FC had developed outside the United States. Through FC's direct efforts, U.S. sales of the software produced income effectively connected with a U.S. trade or

business. FC had extensive experience conducting similar business activities in other countries, including making the appropriate tax filings. However, FC's management was aware neither of FC's obligation to file a U.S. income tax return for those years, nor of its ability to file a protective return for those years. FC had never filed a U.S. income tax return before. Despite FC's extensive experience conducting similar business activities in other countries, it made no effort to seek advice in connection with its U.S. tax obligations. FC failed to file either U.S. income tax returns or protective returns for Year 1 and Year 2. In January of Year 4, an Internal Revenue Service examiner asked FC for an explanation of FC's failure to file U.S. income tax returns. FC immediately engaged a U.S. tax advisor, and cooperated with the Internal Revenue Service in determining FC's income tax liability, for example, by preparing and filing the appropriate income tax returns for Year 1 and Year 2 and by making FC's books and records available to the examiner. FC did not present evidence that intervening events beyond its control prevented it from filing a return, and there were no other mitigating factors. FC has not met the standard described in paragraph (a)(3)(ii) of this section for waiver of any applicable filing deadlines in paragraph (a)(3)(i) of this section.

Example 6. Foreign corporation with prior filing history. FC began a U.S. trade or business in Year 1. FC's tax advisor filed the appropriate U.S. income tax returns for Year 1 through Year 6, reporting income effectively connected with FC's U.S. trade or business. In Year 7, FC replaced its tax advisor with a tax advisor unfamiliar with U.S. tax law. FC did not file a U.S. income tax return for any year from Year 7 through Year 10, although it had effectively connected income for those years. FC's management was aware of FC's ability to file a protective return for those years. In Year 11, an Internal Revenue Service examiner contacted FC and asked its chief financial officer for an explanation of FC's failure to file U.S. income tax returns after Year 6. FC immediately engaged a U.S. tax advisor and cooperated with the Internal Revenue Service in determining FC's income tax liability, for example, by preparing and filing the appropriate income tax returns for Year 7 through Year 10 and by making FC's books and records available to the examiner. FC did not present evidence that intervening events beyond its control prevented it from filing a return, and there were no other mitigating factors. FC has not met the standard described in paragraph (a)(3)(ii) of this section for waiver of any applicable filing deadlines in paragraph (a)(3)(i) of this section.

(iv) Paragraphs (a)(3)(ii) and (iii) of this section are applicable to open years for which a request for a waiver is filed on or after January 29, 2002.

(v) A foreign corporation which has a permanent establishment, as defined in an income tax treaty between the United States and the foreign corporation's country of residence, in the United States is subject to the filing deadlines set forth in paragraph (a)(3)(i) of this section.

(vi) If a foreign corporation conducts limited activities in the United States in a taxable year which the foreign corporation determines does not give rise to gross income which is effectively connected with the conduct of a trade or business within the United States as defined in sections 882(b) and 864 (b) and (c) and the regulations under those sections, the foreign corporation may nonetheless file a return for that taxable year on a timely basis under paragraph (a)(3)(i) of this section and thereby protect the right to receive the benefit of the deductions and credits attributable to that gross income if it is later determined, after the return was filed, that the original determination was incorrect. On that timely filed return, the foreign corporation is not required to report any gross income as effectively connected with a United States trade or business or any deductions or credits but should attach a statement indicating that the return is being filed for the reason set forth in this paragraph (a)(3). If the foreign corporation determines that part of the activities which it conducts in the United States in a taxable year gives rise to gross income which is effectively connected with the conduct of a trade or business and part does not, the foreign corporation must timely file a return for that taxable year to report the gross income determined to be effectively connected, or treated as effectively connected, with the conduct of the trade or business within the United States and the deductions and credits attributable to the gross income. In addition, the foreign corporation should attach to that return the statement described in this paragraph (b)(3) with regard to the other activities. The foreign corporation may follow the same procedure if it determines initially

that it has no United States tax liability under the provisions of an applicable income tax treaty. In the event the foreign corporation relies on the provisions of an income tax treaty to reduce or eliminate the income subject to taxation, or to reduce the rate of tax, disclosure may be required pursuant to section 6114.

(vii) In order to be eligible for any deductions and credits for purposes of computing the accumulated earnings tax of section 531, a foreign corporation must file a true and accurate return; on a timely basis, in the manner as set forth in paragraph (a) (2) and (3) of this section.

(4) *Return by Internal Revenue Service.* If a foreign corporation has various sources of income within the United States and a return of income has not been filed, in the manner prescribed by subtitle F, including the filing deadlines set forth in paragraph (a)(3) of this section, the Internal Revenue Service shall:

(i) Cause a return of income to be made,

(ii) Include on the return the income described in §1.882–1 of that corporation from all sources concerning which it has information, and

(iii) Assess the tax and collect it from one or more of those sources of income within the United States, without allowance for any deductions (other than that allowed by section 170) or credits (other than those allowed by sections 33, 34 and 852(b)(3)(D)(ii)).

If the income of the corporation is not effectively connected with, or if the corporation did not receive income that is treated as being effectively connected with, the conduct of a United States trade or business, the tax will be assessed under §1.882–1(b)(1) on a gross basis, without allowance for any deduction (other than that allowed by section 170) or credit (other than the credits allowed by sections 33, 34 and 852(b)(3)(D)(ii)). If the income is effectively connected, or treated as effectively connected, with the conduct of a United States trade on business, tax will be assessed in accordance with either section 11, 55 or 1201(a) without allowance for any deduction (other than that allowed by section 170) or credit (other than the credits allowed by sections 33, 34 and 852(b)(3)(D)(ii)).

(b) *Allowed deductions and credits*—(1) *In general.* Except for the deduction allowed under section 170 for charitable contributions and gifts (see section 882(c)(1)(B)), deductions are allowed to a foreign corporation only to the extent they are connected with gross income which is effectively connected, or treated as effectively connected, with the conduct of a trade or business in the United States. Deductible expenses (other than interest expense) are properly allocated and apportioned to effectively connected gross income in accordance with the rules of §1.861–8. For the method of determining the interest deduction allowed to a foreign corporation, see §1.882–5. Other than the credits allowed by sections 33, 34 and 852(b)(3)(D)(ii), the foreign corporation is entitled to credits only if they are attributable to effectively connected income. See paragraph (a)(2) of this section for the requirement that a return be filed. Except as provided by section 906, a foreign corporation shall not be allowed the credit against the tax for taxes of foreign countries and possessions of the United States allowed by section 901.

(2) *Verification.* At the request of the Internal Revenue Service, a foreign corporation claiming deductions from gross income which is effectively connected, or treated as effectively connected, with the conduct of a trade or business in the United States or credits which are attributable to that income must furnish at the place designated pursuant to §301.7605–1(a) information sufficient to establish that the corporation is entitled to the deductions and credits in the amounts claimed. All information must be furnished in a form suitable to permit verification of claimed deductions and credits. The Internal Revenue Service may require, as appropriate, that an English translation be provided with any information in a foreign language. If a foreign corporation fails to furnish sufficient information, the Internal Revenue Service may in its discretion disallow any claimed deductions and credits in full or in part. For additional filing requirements and for penalties for failure

to provide information, see also section 6038A.

[T.D. 8322, 55 FR 50830, Dec. 11, 1990, as amended by T.D. 8981, 67 FR 4175, Jan. 29, 2002; T.D. 9043, 68 FR 11314, Mar. 10, 2003]

§ 1.882–5 Determination of interest deduction.

(a)(1) *Overview*—(i) *In general.* The amount of interest expense of a foreign corporation that is allocable under section 882(c) to income which is (or is treated as) effectively connected with the conduct of a trade or business within the United States (ECI) is the sum of the interest allocable by the foreign corporation under the three-step process set forth in paragraphs (b), (c), and (d) of this section and the specially allocated interest expense determined under paragraph (a)(1)(ii) of this section. The provisions of this section provide the exclusive rules for allocating interest expense to the ECI of a foreign corporation under section 882(c). Under the three-step process, the total value of the U.S. assets of a foreign corporation is first determined under paragraph (b) of this section (Step 1). Next, the amount of U.S.-connected liabilities is determined under paragraph (c) of this section (Step 2). Finally, the amount of interest paid or accrued on U.S.-booked liabilities, as determined under paragraph (d)(2) of this section, is adjusted for interest expense attributable to the difference between U.S.-connected liabilities and U.S.-booked liabilities (Step 3). Alternatively, a foreign corporation may elect to determine its interest rate on U.S.-connected liabilities by reference to its U.S. assets, using the separate currency pools method described in paragraph (e) of this section.

(ii) *Direct allocations*—(A) *In general.* A foreign corporation that has a U.S. asset and indebtedness that meet the requirements of § 1.861–10T (b) or (c), as limited by § 1.861–10T(d)(1), shall directly allocate interest expense from such indebtedness to income from such asset in the manner and to the extent provided in § 1.861–10T. For purposes of paragraph (b)(1) or (c)(2) of this section, a foreign corporation that allocates its interest expense under the direct allocation rule of this paragraph (a)(1)(ii)(A) shall reduce the basis of the asset that meets the requirements of § 1.861–10T (b) or (c) by the principal amount of the indebtedness that meets the requirements of § 1.861- 10T (b) or (c). The foreign corporation shall also disregard any indebtedness that meets the requirements of § 1.861–10T (b) or (c) in determining the amount of the foreign corporation's liabilities under paragraphs (c)(2) and (d)(2) of this section and shall not take into account any interest expense paid or accrued with respect to such a liability for purposes of paragraph (d) or (e) of this section.

(B) *Partnership interest.* A foreign corporation that is a partner in a partnership that has a U.S. asset and indebtedness that meet the requirements of § 1.861–10T (b) or (c), as limited by § 1.861–10T(d)(1), shall directly allocate its distributive share of interest expense from that indebtedness to its distributive share of income from that asset in the manner and to the extent provided in § 1.861–10T. A foreign corporation that allocates its distributive share of interest expense under the direct allocation rule of this paragraph (a)(1)(ii)(B) shall disregard any partnership indebtedness that meets the requirements of § 1.861–10T (b) or (c) in determining the amount of its distributive share of partnership liabilities for purposes of paragraphs (b)(1), (c)(2)(vi), and (d)(2)(vii) or (e)(1)(ii) of this section, and shall not take into account any partnership interest expense paid or accrued with respect to such a liability for purposes of paragraph (d) or (e) of this section. For purposes of paragraph (b)(1) of this section, a foreign corporation that directly allocates its distributive share of interest expense under this paragraph (a)(1)(ii)(B) shall—

(*1*) Reduce the partnership's basis in such asset by the amount of such indebtedness in allocating its basis in the partnership under § 1.884–1(d)(3)(ii); or

(*2*) Reduce the partnership's income from such asset by the partnership's interest expense from such indebtedness under § 1.884–1(d)(3)(iii).

(2) *Coordination with tax treaties.* Except as expressly provided by or pursuant to a U.S. income tax treaty or accompanying documents (such as an exchange of notes), the provisions of this

section provide the exclusive rules for determining the interest expense attributable to the business profits of a permanent establishment under a U.S. income tax treaty.

(3) *Limitation on interest expense.* In no event may the amount of interest expense computed under this section exceed the amount of interest on indebtedness paid or accrued by the taxpayer within the taxable year (translated into U.S. dollars at the weighted average exchange rate for each currency prescribed by §1.989(b)–1 for the taxable year).

(4) *Translation convention for foreign currency.* For each computation required by this section, the taxpayer shall translate values and amounts into the relevant currency at a spot rate or a weighted average exchange rate consistent with the method such taxpayer uses for financial reporting purposes, provided such method is applied consistently from year to year. Interest expense paid or accrued, however, shall be translated under the rules of §1.988–2. The director of field operations or the Assistant Commissioner (International) may require that any or all computations required by this section be made in U.S. dollars if the functional currency of the taxpayer's home office is a hyperinflationary currency, as defined in §1.985–1, and the computation in U.S. dollars is necessary to prevent distortions.

(5) *Coordination with other sections.* Any provision that disallows, defers, or capitalizes interest expense applies after determining the amount of interest expense allocated to ECI under this section. For example, in determining the amount of interest expense that is disallowed as a deduction under section 265 or 163(j), deferred under section 163(e)(3) or 267(a)(3), or capitalized under section 263A with respect to a United States trade or business, a taxpayer takes into account only the amount of interest expense allocable to ECI under this section.

(6) *Special rule for foreign governments.* The amount of interest expense of a foreign government, as defined in §1.892–2T(a), that is allocable to ECI is the total amount of interest paid or accrued within the taxable year by the United States trade or business on U.S. booked liabilities (as defined in paragraph (d)(2) of this section). Interest expense of a foreign government, however, is not allocable to ECI to the extent that it is incurred with respect to U.S. booked liabilities that exceed 80 percent of the total value of U.S. assets for the taxable year (determined under paragraph (b) of this section). This paragraph (a)(6) does not apply to controlled commercial entities within the meaning of §1.892–5T.

(7) *Elections under §1.882–5*—(i) *In general.* A corporation must make each election provided in this section on the corporation's original timely filed Federal income tax return for the first taxable year it is subject to the rules of this section. An amended return does not qualify for this purpose, nor shall the provisions of §301.9100–1 of this chapter and any guidance promulgated thereunder apply. Except as provided elsewhere in this section, each election under this section, whether an election for the first taxable year or a subsequent change of election, shall be made by indicating the method used on Schedule I (Form 1120–F) attached to the corporation's timely filed return. An elected method (other than the fair market value method under paragraph (b)(2)(ii) of this section, or the annual 30-day London Interbank Offered Rate (LIBOR) election in paragraph (d)(5)(ii) of this section) must be used for a minimum period of five years before the taxpayer may elect a different method. To change an election before the end of the requisite five-year period, a taxpayer must obtain the consent of the Commissioner or his delegate. The Commissioner or his delegate will generally consent to a taxpayer's request to change its election only in rare and unusual circumstances. After the five-year minimum period, an elected method may be changed for any subsequent year on the foreign corporation's original timely filed tax return for the first year to which the changed election applies.

(ii) *Failure to make the proper election.* If a taxpayer, for any reason, fails to make an election provided in this section in a timely fashion, the Director of Field Operations may make any or

all of the elections provided in this section on behalf of the taxpayer, and such elections shall be binding as if made by the taxpayer.

(iii) *Step 2 special election for banks.* For the first taxable year for which an original income tax return is due (including extensions) after August 17, 2006, in which a taxpayer that is a bank as described in paragraph (c)(4) of this section is subject to the requirements of this section, a taxpayer may make a new election to use the fixed ratio on an original timely filed return. A new fixed ratio election may be made in any subsequent year subject to the timely filing and five-year minimum period requirements of paragraph (a)(7)(i) of this section. A new fixed ratio election under this paragraph (a)(7)(iii) is subject to the adjusted basis or fair market value conforming election requirements of paragraph (b)(2)(ii)(A)(*2*) of this section and may not be made if a taxpayer elects or maintains a fair market value election for purposes of paragraph (b) of this section. Taxpayers that already use the fixed ratio method under an existing election may continue to use the new fixed ratio at the higher percentage without having to make a new five-year election in the first year that the higher percentage is effective.

(8) *Examples.* The following examples illustrate the application of paragraph (a) of this section:

Example 1. Direct allocations. (i) *Facts: FC* is a foreign corporation that conducts business through a branch, *B*, in the United States. Among *B*'s U.S. assets is an interest in a partnership, *P*, that is engaged in airplane leasing solely in the U.S. *FC* contributes 200 × to *P* in exchange for its partnership interest. *P* incurs qualified nonrecourse indebtedness within the meaning of §1.861–10T to purchase an airplane. *FC*'s share of the liability of *P*, as determined under section 752, is 800 ×.

(ii) *Analysis:* Pursuant to paragraph (a)(1)(ii)(B) of this section, *FC* is permitted to directly allocate its distributive share of the interest incurred with respect to the qualified nonrecourse indebtedness to *FC*'s distributive share of the rental income generated by the airplane. A liability the interest on which is allocated directly to the income from a particular asset under paragraph (a)(1)(ii)(B) of this section is disregarded for purposes of paragraphs (b)(1), (c)(2)(vi), and (d)(2)(vii) or (e)(1)(ii) of this section. Consequently, for purposes of determining the value of *FC*'s assets under paragraphs (b)(1) and (c)(2)(vi) of this section, *FC*'s basis in *P* is reduced by the 800 × liability as determined under section 752, but is not increased by the 800 × liability that is directly allocated under paragraph (a)(1)(ii)(B) of this section. Similarly, pursuant to paragraph (a)(1)(ii)(B) of this section, the 800 × liability is disregarded for purposes of determining *FC*'s liabilities under paragraphs (c)(2)(vi) and (d)(2)(vii) of this section.

Example 2. Limitation on interest expense. (i) *FC* is a foreign corporation that conducts a real estate business in the United States. In its 1997 tax year, *FC* has no outstanding indebtedness, and therefore incurs no interest expense. *FC* elects to use the 50% fixed ratio under paragraph (c)(4) of this section.

(ii) Under paragraph (a)(3) of this section, *FC* is not allowed to deduct any interest expense that exceeds the amount of interest on indebtedness paid or accrued in that taxable year. Since *FC* incurred no interest expense in taxable year 1997, *FC* will not be entitled to any interest deduction for that year under §1.882–5, notwithstanding the fact that *FC* has elected to use the 50% fixed ratio.

Example 3. Coordination with other sections. (i) *FC* is a foreign corporation that is a bank under section 585(a)(2) and a financial institution under section 265(b)(5). *FC* is a calendar year taxpayer, and operates a U.S. branch, *B*. Throughout its taxable year 1997, *B* holds only two assets that are U.S. assets within the meaning of paragraph (b)(1) of this section. *FC* does not make a fair-market value election under paragraph (b)(2)(ii) of this section, and, therefore, values its U.S. assets according to their bases under paragraph (b)(2)(i) of this section. The first asset is a taxable security with an adjusted basis of $100. The second asset is an obligation the interest on which is exempt from federal taxation under section 103, with an adjusted basis of $50. The tax-exempt obligation is not a qualified tax-exempt obligation as defined by section 265(b)(3)(B).

(ii) *FC* calculates its interest expense under §1.882–5 to be $12. Under paragraph (a)(5) of this section, however, a portion of the interest expense that is allocated to *FC*'s effectively connected income under §1.882–5 is disallowed in accordance with the provisions of section 265(b). Using the methodology prescribed under section 265, the amount of disallowed interest expense is $4, calculated as follows:

$$\$12 \times \frac{\$50 \text{ Tax-exempt U.S. assets}}{\$150 \text{ Total U.S. assets}} = \$4$$

(iii) Therefore, *FC* deducts a total of $8 ($12–$4) of interest expense attributable to its effectively connected income in 1997.

Example 4. Treaty exempt asset. (i) *FC* is a foreign corporation, resident in Country X, that is actively engaged in the banking business in the United States through a permanent establishment, *B*. The income tax treaty in effect between Country X and the United States provides that *FC* is not taxable on foreign source income earned by its U.S. permanent establishment. In its 1997 tax year, *B* earns $90 of U.S. source income from U.S. assets with an adjusted tax basis of $900, and $12 of foreign source interest income from U.S. assets with an adjusted tax basis of $100. *FC*'s U.S. interest expense deduction, computed in accordance with §1.882–5, is $500.

(ii) Under paragraph (a)(5) of this section, *FC* is required to apply any provision that disallows, defers, or capitalizes interest expense after determining the interest expense allocated to ECI under §1.882–5. Section 265(a)(2) disallows interest expense that is allocable to one or more classes of income that are wholly exempt from taxation under subtitle A of the Internal Revenue Code. Section 1.265–1(b) provides that income wholly exempt from taxes includes both income excluded from tax under any provision of subtitle A and income wholly exempt from taxes under any other law. Section 894 specifies that the provisions of subtitle A are applied with due regard to any relevant treaty obligation of the United States. Because the treaty between the United States and Country X exempts foreign source income earned by B from U.S. tax, *FC* has assets that produce income wholly exempt from taxes under subtitle A, and must therefore allocate a portion of its §1.882–5 interest expense to its exempt income. Using the methodology prescribed under section 265, the amount of disallowed interest expense is $50, calculated as follows:

$$\$500 \times \frac{\$100\ \text{Treaty-exempt U.S. assets}}{\$1000\ \text{Total U.S. assets}} = \$50$$

(iii) Therefore, *FC* deducts a total of $450 ($500–$50) of interest expense attributable to its effectively connected income in 1997.

(b) *Step 1: Determination of total value of U.S. assets for the taxable year*—(1) *Classification of an asset as a U.S. asset*—(i) *General rule*. Except as otherwise provided in this paragraph (b)(1), an asset is a U.S. asset for purposes of this section to the extent that it is a U.S. asset under §1.884–1(d). For purposes of this section, the term *determination date*, as used in §1.884–1(d), means each day for which the total value of U.S. assets is computed under paragraph (b)(3) of this section.

(ii) *Items excluded from the definition of U.S. asset*. For purposes of this section, the term *U.S. asset* excludes an asset to the extent it produces income or gain described in sections 883 (a)(3) and (b).

(iii) *Items included in the definition of U.S. asset*. For purposes of this section, the term *U.S. asset* includes—

(A) U.S. real property held in a wholly-owned domestic subsidiary of a foreign corporation that qualifies as a bank under section 585(a)(2)(B) (without regard to the second sentence thereof), provided that the real property would qualify as used in the foreign corporation's trade or business within the meaning of §1.864–4(c) (2) or (3) if held directly by the foreign corporation and either was initially acquired through foreclosure or similar proceedings or is U.S. real property occupied by the foreign corporation (the value of which shall be adjusted by the amount of any indebtedness that is reflected in the value of the property);

(B) An asset that produces income treated as ECI under section 921(d) or 926(b) (relating to certain income of a FSC and certain dividends paid by a FSC to a foreign corporation);

(C) An asset that produces income treated as ECI under section 953(c)(3)(C) (relating to certain income of a captive insurance company that a corporation elects to treat as ECI) that is not otherwise ECI; and

(D) An asset that produces income treated as ECI under section 882(e) (relating to certain interest income of possessions banks).

(iv) *Interbranch transactions*. A transaction of any type between separate offices or branches of the same taxpayer does not create a U.S. asset.

(v) *Assets acquired to increase U.S. assets artificially*. An asset shall not be treated as a U.S. asset if one of the

principal purposes for acquiring or using that asset is to increase artificially the U.S. assets of a foreign corporation on the determination date. Whether an asset is acquired or used for such purpose will depend upon all the facts and circumstances of each case. Factors to be considered in determining whether one of the principal purposes in acquiring or using an asset is to increase artificially the U.S. assets of a foreign corporation include the length of time during which the asset was used in a U.S. trade or business, whether the asset was acquired from a related person, and whether the aggregate value of the U.S. assets of the foreign corporation increased temporarily on or around the determination date. A purpose may be a principal purpose even though it is outweighed by other purposes (taken together or separately).

(2) *Determination of the value of a U.S. asset*—(i) *General rule.* The value of a U.S. asset is the adjusted basis of the asset for determining gain or loss from the sale or other disposition of that item, further adjusted as provided in paragraph (b)(2)(iii) of this section.

(ii) *Fair-market value election*—

(A) *In general*—(*1*) *Fair market value conformity requirement.* A taxpayer may elect to value all of its U.S. assets on the basis of fair market value, subject to the requirements of §1.861–9T(g)(1)(iii), and provided the taxpayer is eligible and uses the actual ratio method under paragraph (c)(2) of this section and the methodology prescribed in §1.861–9T(h). Once elected, the fair market value must be used by the taxpayer for both Step 1 and Step 2 described in paragraphs (b) and (c) of this section, and must be used in all subsequent taxable years unless the Commissioner or his delegate consents to a change.

(*2*) *Conforming election requirement.* Taxpayers that as of the effective date of this paragraph (b)(2)(ii)(A)(*2*) have elected and currently use both the fair market value method for purposes of paragraph (b) of this section and a fixed ratio for purposes of paragraph (c)(4) of this section must conform either the adjusted basis or fair market value methods in Step 1 and Step 2 of the allocation formula by making an adjusted basis election for paragraph (b) of this section purposes while continuing the fixed ratio for Step 2, or by making an actual ratio election under paragraph (c)(2) of this section while remaining on the fair market value method under paragraph (b) of this section. Taxpayers who elect to conform Step 1 and Step 2 of the formula to the adjusted basis method must remain on both methods for the minimum five-year period in accordance with the provisions of paragraph (a)(7) of this section. Taxpayers that elect to conform Step 1 and Step 2 of the formula to the fair market value method must remain on the actual ratio method until the consent of the Commissioner or his delegate is obtained to switch to the adjusted basis method. If consent to use the adjusted basis method in Step 1 is granted in a later year, the taxpayer must remain on the actual ratio method for the minimum five-year period unless consent to use the fixed ratio is independently obtained under the requirements of paragraph (a)(7) of this section. For the first taxable year for which an original income tax return is due (including extensions) after August 17, 2006, taxpayers that are required to make a conforming election under this paragraph (b)(2)(ii)(A)(*2*), may do so on an original timely filed return. If a conforming election is not made within the timeframe provided in this paragraph, the Director of Field Operations or his delegate may make the conforming elections in accordance with the provisions of paragraph (a)(7)(ii) of this section.

(B) *Adjustment to partnership basis.* If a partner makes a fair market value election under paragraph (b)(2)(ii) of this section, the value of the partner's interest in a partnership that is treated as an asset shall be the fair market value of his partnership interest, increased by the fair market value of the partner's share of the liabilities determined under paragraph (c)(2)(vi) of this section. See §1.884–1(d)(3).

(iii) *Reduction of total value of U.S. assets by amount of bad debt reserves under section 585*—(A) *In general.* The total value of loans that qualify as U.S. assets shall be reduced by the amount of any reserve for bad debts additions to

which are allowed as deductions under section 585.

(B) *Example*. The following example illustrates the provisions of paragraph (b)(2)(iii)(A) of this section:

Example. Foreign banks; bad debt reserves. FC is a foreign corporation that qualifies as a bank under section 585(a)(2)(B) (without regard to the second sentence thereof), but is not a large bank as defined in section 585(c)(2). *FC* conducts business through a branch, *B*, in the United States. Among *B*'s U.S. assets are a portfolio of loans with an adjusted basis of $500. *FC* accounts for its bad debts for U.S. federal income tax purposes under the reserve method, and *B* maintains a deductible reserve for bad debts of $50. Under paragraph (b)(2)(iii) of this section, the total value of *FC*'s portfolio of loans is $450 ($500 − $50).

(3) *Computation of total value of U.S. assets*—(i) *General rule*. The total value of U.S. assets for the taxable year is the average of the sums of the values (determined under paragraph (b)(2) of this section) of U.S. assets. For each U.S. asset, value shall be computed at the most frequent regular intervals for which data are reasonably available. In no event shall the value of any U.S. asset be computed less frequently than monthly (beginning of taxable year and monthly thereafter) by a large bank (as defined in section 585(c)(2)) or a dealer in securities (within the meaning of section 475) and semi-annually (beginning, middle and end of taxable year) by any other taxpayer.

(ii) *Adjustment to basis of financial instruments*. For purposes of determining the total average value of U.S. assets in this paragraph (b)(3), the value of a security or contract that is marked to market pursuant to section 475 or section 1256 shall be determined as if each determination date is the most frequent regular interval for which data are reasonably available that reflects the taxpayer's consistent business practices for reflecting mark-to-market valuations on its books and records.

(c) *Step 2: Determination of total amount of U.S.-connected liabilities for the taxable year*—(1) *General rule*. The amount of U.S.-connected liabilities for the taxable year equals the total value of U.S. assets for the taxable year (as determined under paragraph (b)(3) of this section) multiplied by the actual ratio for the taxable year (as determined under paragraph (c)(2) of this section) or, if the taxpayer has made an election in accordance with paragraph (c)(4) of this section, by the fixed ratio.

(2) *Computation of the actual ratio*—(i) *In general*. A taxpayer's actual ratio for the taxable year is the total amount of its worldwide liabilities for the taxable year divided by the total value of its worldwide assets for the taxable year. The total amount of worldwide liabilities and the total value of worldwide assets for the taxable year is the average of the sums of the amounts of the taxpayer's worldwide liabilities and the values of its worldwide assets (determined under paragraphs (c)(2) (iii) and (iv) of this section). In each case, the sums must be computed semi-annually (beginning, middle and end of taxable year) by a large bank (as defined in section 585(c)(2)) and annually (beginning and end of taxable year) by any other taxpayer.

(ii) *Classification of items*. The classification of an item as a liability or an asset must be consistent from year to year and in accordance with U.S. tax principles.

(iii) *Determination of amount of worldwide liabilities*. The amount of a liability must be determined consistently from year to year and must be substantially in accordance with U.S. tax principles. To be substantially in accordance with U.S. tax principles, the principles used to determine the amount of a liability must not differ from U.S. tax principles to a degree that will materially affect the value of taxpayer's worldwide liabilities or the taxpayer's actual ratio.

(iv) *Determination of value of worldwide assets*. The value of an asset must be determined consistently from year to year and must be substantially in accordance with U.S. tax principles. To be substantially in accordance with U.S. tax principles, the principles used to determine the value of an asset must not differ from U.S. tax principles to a degree that will materially affect the value of the taxpayer's worldwide assets or the taxpayer's actual ratio. The value of an asset is the adjusted basis of that asset for determining the

gain or loss from the sale or other disposition of that asset, adjusted in the same manner as the basis of U.S. assets are adjusted under paragraphs (b)(2) (ii) through (iv) of this section. The rules of paragraph (b)(3) of this section apply in determining the total value of applicable worldwide assets for the taxable year, except that the minimum number of determination dates are those stated in paragraph (c)(2)(i) of this section.

(v) *Hedging transactions.* [Reserved]

(vi) *Treatment of partnership interests and liabilities.* For purposes of computing the actual ratio, the value of a partner's interest in a partnership that will be treated as an asset is the partner's adjusted basis in its partnership interest, reduced by the partner's share of liabilities of the partnership as determined under section 752 and increased by the partner's share of liabilities determined under this paragraph (c)(2)(vi). If the partner has made a fair market value election under paragraph (b)(2)(ii) of this section, the value of its interest in the partnership shall be increased by the fair market value of the partner's share of the liabilities determined under this paragraph (c)(2)(vi). For purposes of this section a partner shares in any liability of a partnership in the same proportion that it shares, for income tax purposes, in the expense attributable to that liability for the taxable year. A partner's adjusted basis in a partnership interest cannot be less than zero.

(vii) *Computation of actual ratio of insurance companies.* [Reserved]

(viii) *Interbranch transactions.* A transaction of any type between separate offices or branches of the same taxpayer does not create an asset or a liability.

(ix) *Amounts must be expressed in a single currency.* The actual ratio must be computed in either U.S. dollars or the functional currency of the home office of the taxpayer, and that currency must be used consistently from year to year. For example, a taxpayer that determines the actual ratio annually using British pounds converted at the spot rate for financial reporting purposes must translate the U.S. dollar values of assets and amounts of liabilities of the U.S. trade or business into pounds using the spot rate on the last day of its taxable year. The director of field operations or the Assistant Commissioner (International) may require that the actual ratio be computed in dollars if the functional currency of the taxpayer's home office is a hyperinflationary currency, as defined in § 1.985–1, that materially distorts the actual ratio.

(3) *Adjustments.* The director of field operations or the Assistant Commissioner (International) may make appropriate adjustments to prevent a foreign corporation from intentionally and artificially increasing its actual ratio. For example, the director of field operations or the Assistant Commissioner (International) may offset a loan made from or to one person with a loan made to or from another person if any of the parties to the loans are related persons, within the meaning of section 267(b) or 707(b)(1), and one of the principal purposes for entering into the loans was to increase artificially the actual ratio of a foreign corporation. A purpose may be a principal purpose even though it is outweighed by other purposes (taken together or separately).

(4) *Elective fixed ratio method of determining U.S. liabilities.* A taxpayer that is a bank as defined in section 585(a)(2)(B) (without regard to the second sentence thereof or whether any such activities are effectively connected with a trade or business within the United States) may elect to use a fixed ratio of 95 percent in lieu of the actual ratio. A taxpayer that is neither a bank nor an insurance company may elect to use a fixed ratio of 50 percent in lieu of the actual ratio.

(5) *Examples.* The following examples illustrate the application of paragraph (c) of this section:

Example 1. Classification of item not in accordance with U.S. tax principles. Bank *Z*, a resident of country *X*, has a branch in the United States through which it conducts its banking business. In preparing its financial statements in country *X*, *Z* treats an instrument documented as perpetual subordinated debt as a liability. Under U.S. tax principles, however, this instrument is treated as equity. Consequently, the classification of this instrument as a liability for purposes of paragraph (c)(2)(iii) of this section is not in accordance with U.S. tax principles.

Example 2. Valuation of item not substantially in accordance with U.S. tax principles. Bank *Z*, a resident of country *X*, has a branch in the United States through which it conducts its banking business. Bank *Z* is a large bank as defined in section 585(c)(2). The tax rules of country *X* allow Bank *Z* to take deductions for additions to certain reserves. Bank *Z* decreases the value of the assets on its financial statements by the amounts of the reserves. The additions to the reserves under country *X* tax rules cause the value of Bank *Z*'s assets to differ from the value of those assets determined under U.S. tax principles to a degree that materially affects the value of taxpayer's worldwide assets. Consequently, the valuation of Bank *Z*'s worldwide assets under country *X* tax principles is not substantially in accordance with U.S. tax principles. Bank *Z* must increase the value of its worldwide assets under paragraph (c)(2)(iii) of this section by the amount of its country *X* reserves.

Example 3. Valuation of item substantially in accordance with U.S. tax principles. Bank *Z*, a resident of country *X*, has a branch in the United States through which it conducts its banking business. In determining the value of its worldwide assets, Bank *Z* computes the adjusted basis of certain non-U.S. assets according to the depreciation methodology provided under country *X* tax laws, which is different than the depreciation methodology provided under U.S. tax law. If the depreciation methodology provided under country *X* tax laws does not differ from U.S. tax principles to a degree that materially affects the value of Bank *Z*'s worldwide assets or Bank *Z*'s actual ratio as computed under paragraph (c)(2) of this section, then the valuation of Bank *Z*'s worldwide assets under paragraph (c)(2)(iv) of this section is substantially in accordance with U.S. tax principles.

Example 4. [Reserved]

Example 5. Adjustments. FC is a foreign corporation engaged in the active conduct of a banking business through a branch, *B*, in the United States. *P*, an unrelated foreign corporation, deposits $100,000 in the home office of *FC*. Shortly thereafter, in a transaction arranged by the home office of *FC*, *B* lends $80,000 bearing interest at an arm's length rate to *S*, a wholly owned U.S. subsidiary of *P*. The director of field operations or the Assistant Commissioner (International) determines that one of the principal purposes for making and incurring such loans is to increase *FC*'s actual ratio. For purposes of this section, therefore, *P* is treated as having directly lent $80,000 to S. Thus, for purposes of paragraph (c) of this section (Step 2), the director of field operations or the Assistant Commissioner (International) may offset *FC*'s liability and asset arising from this transaction, resulting in a net liability of $20,000 that is not a booked liability of *B*. Because the loan to *S* from *B* was initiated and arranged by the home office of *FC*, with no material participation by *B*, the loan to *S* will not be treated as a U.S. asset.

(d) *Step 3: Determination of amount of interest expense allocable to ECI under the adjusted U.S. booked liabilities method*—(1) *General rule.* The adjustment to the amount of interest expense paid or accrued on U.S. booked liabilities is determined by comparing the amount of U.S.-connected liabilities for the taxable year, as determined under paragraph (c) of this section, with the average total amount of U.S. booked liabilities, as determined under paragraphs (d)(2) and (3) of this section. If the average total amount of U.S. booked liabilities equals or exceeds the amount of U.S.-connected liabilities, the adjustment to the interest expense on U.S. booked liabilities is determined under paragraph (d)(4) of this section. If the amount of U.S.-connected liabilities exceeds the average total amount of U.S. booked liabilities, the adjustment to the amount of interest expense paid or accrued on U.S. booked liabilities is determined under paragraph (d)(5) of this section.

(2) *U.S. booked liabilities*—(i) *In general.* A liability is a *U.S. booked liability* if it is properly reflected on the books of the U.S. trade or business, within the meaning of paragraph (d)(2)(ii) or (iii) of this section.

(ii) *Properly reflected on the books of the U.S. trade or business of a foreign corporation that is not a bank*—(A) *In general.* A liability, whether interest bearing or non-interest bearing, is properly reflected on the books of the U.S. trade or business of a foreign corporation that is not a bank as described in section 585(a)(2)(B) (without regard to the second sentence thereof) if—

(*1*) The liability is secured predominantly by a U.S. asset of the foreign corporation;

(*2*) The foreign corporation enters the liability on a set of books reasonably contemporaneously with the time at which the liability is incurred and the liability relates to an activity that produces ECI.

(*3*) The foreign corporation maintains a set of books and records relating to an activity that produces ECI and the Director of Field Operations determines that there is a direct connection

or relationship between the liability and that activity. Whether there is a direct connection between the liability and an activity that produces ECI depends on the facts and circumstances of each case.

(B) *Identified liabilities not properly reflected.* A liability is not properly reflected on the books of the U.S. trade or business merely because a foreign corporation identifies the liability pursuant to §1.884–4(b)(1)(ii) and (b)(3).

(iii) *Properly reflected on the books of the U.S. trade or business of a foreign corporation that is a bank*—

(A) *In general.* A liability, whether interest bearing or non-interest bearing, is properly reflected on the books of the U.S. trade or business of a foreign corporation that is a bank as described in section 585(a)(2)(B) (without regard to the second sentence thereof) if—

(*1*) The bank enters the liability on a set of books before the close of the day on which the liability is incurred, and the liability relates to an activity that produces ECI; and

(*2*) There is a direct connection or relationship between the liability and that activity. Whether there is a direct connection between the liability and an activity that produces ECI depends on the facts and circumstances of each case. For example, a liability that is used to fund an interbranch or other asset that produces non-ECI may have a direct connection to an ECI producing activity and may constitute a U.S.-booked liability if both the interbranch or non-ECI activity is the same type of activity in which ECI assets are also reflected on the set of books (for example, lending or money market interbank placements), and such ECI activities are not de minimis. Such U.S. booked liabilities may still be subject to paragraph (d)(2)(v) of this section.

(B) *Inadvertent error.* If a bank fails to enter a liability in the books of the activity that produces ECI before the close of the day on which the liability was incurred, the liability may be treated as a U.S. booked liability only if, under the facts and circumstances, the taxpayer demonstrates a direct connection or relationship between the liability and the activity that produces ECI and the failure to enter the liability in those books was due to inadvertent error.

(iv) *Liabilities of insurance companies.* [Reserved]

(v) *Liabilities used to increase artificially interest expense on U.S. booked liabilities.* U.S. booked liabilities shall not include a liability if one of the principal purposes for incurring or holding the liability is to increase artificially the interest expense on the U.S. booked liabilities of a foreign corporation. Whether a liability is incurred or held for the purpose of artificially increasing interest expense will depend upon all the facts and circumstances of each case. Factors to be considered in determining whether one of the principal purposes for incurring or holding a liability is to increase artificially the interest expense on U.S. booked liabilities of a foreign corporation include whether the interest expense on the liability is excessive when compared to other liabilities of the foreign corporation denominated in the same currency and whether the currency denomination of the liabilities of the U.S. branch substantially matches the currency denomination of the U.S. branch's assets. A purpose may be a principal purpose even though it is outweighed by other purposes (taken together or separately).

(vi) *Hedging transactions.* [Reserved]

(vii) *Amount of U.S. booked liabilities of a partner.* A partner's share of liabilities of a partnership is considered a booked liability of the partner provided that it is properly reflected on the books (within the meaning of paragraph (d)(2)(ii) of this section) of the U.S. trade or business of the partnership.

(viii) *Interbranch transactions.* A transaction of any type between separate offices or branches of the same taxpayer does not result in the creation of a liability.

(3) *Average total amount of U.S. booked liabilities.* The *average total amount* of U.S. booked liabilities for the taxable year is the average of the sums of the amounts (determined under paragraph (d)(2) of this section) of U.S. booked liabilities. The amount of U.S. booked liabilities shall be computed at the most frequent, regular intervals for which data are reasonably available. In no

event shall the amount of U.S. booked liabilities be computed less frequently than monthly by a large bank (as defined in section 585(c)(2)) and semi-annually by any other taxpayer.

(4) *Interest expense where U.S. booked liabilities equal or exceed U.S. liabilities*—(i) *In general.* If the average total amount of U.S. booked liabilities (as determined in paragraphs (d)(2) and (3) of this section) exceeds the amount of U.S.-connected liabilities (as determined under paragraph (c) of this section (Step 2)), the interest expense allocable to ECI is the product of the total amount of interest paid or accrued within the taxable year by the U.S. trade or business on U.S. booked liabilities and the scaling ratio set out in paragraph (d)(4)(ii) of this section. For purposes of this section, the reduction resulting from the application of the scaling ratio is applied pro-rata to all interest expense paid or accrued by the foreign corporation. A similar reduction in income, expense, gain, or loss from a hedging transaction (as described in paragraph (d)(2)(vi) of this section) must also be determined by multiplying such income, expense, gain, or loss by the scaling ratio. If the average total amount of U.S. booked liabilities (as determined in paragraph (d)(3) of this section) equals the amount of U.S.-connected liabilities (as determined under *Step 2*), the interest expense allocable to ECI is the total amount of interest paid or accrued within the taxable year by the U.S. trade or business on U.S. booked liabilities.

(ii) *Scaling ratio.* For purposes of this section, the scaling ratio is a fraction the numerator of which is the amount of U.S.-connected liabilities and the denominator of which is the average total amount of U.S. booked liabilities.

(iii) *Special rules for insurance companies.* [Reserved]

(5) *U.S.-connected interest rate where U.S. booked liabilities are less than U.S.-connected liabilities*—(i) *In general.* If the amount of U.S.-connected liabilities (as determined under paragraph (c) of this section (Step 2)) exceeds the average total amount of U.S. booked liabilities, the interest expense allocable to ECI is the total amount of interest paid or accrued within the taxable year by the U.S. trade or business on U.S. booked liabilities, plus the excess of the amount of U.S.-connected liabilities over the average total amount of U.S. booked liabilities multiplied by the interest rate determined under paragraph (d)(5)(ii) of this section.

(ii) *Interest rate on excess U.S.-connected liabilities*—(A) *General rule.* The applicable interest rate on excess U.S.-connected liabilities is determined by dividing the total interest expense paid or accrued for the taxable year on U.S.-dollar liabilities that are not U.S.-booked liabilities (as defined in paragraph (d)(2) of this section) and that are shown on the books of the offices or branches of the foreign corporation outside the United States by the average U.S.-dollar denominated liabilities (whether interest-bearing or not) that are not U.S.-booked liabilities and that are shown on the books of the offices or branches of the foreign corporation outside the United States for the taxable year.

(B) *Annual published rate election.* For each taxable year beginning with the first year end for which the original tax return due date (including extensions) is after August 17, 2006, in which a taxpayer is a bank within the meaning of section 585(a)(2)(B) (without regard to the second sentence thereof or whether any such activities are effectively connected with a trade or business within the United States), such taxpayer may elect to compute its excess interest by reference to a published average 30-day London Interbank Offering Rate (LIBOR) for the year. The election may be made for any eligible year by indicating the rate used on Schedule I (Form 1120–F) attached to the timely filed return. Once selected, the rate may not be changed by the taxpayer. If a taxpayer that is eligible to make the 30-day LIBOR election either does not file a timely return or files a calculation that allocates interest expense under the scaling ratio in paragraph (d)(4) of this section and it is determined by the Director of Field Operations that the taxpayer's U.S.-connected liabilities exceed its U.S.-booked liabilities, then the Director of Field Operations, and not the taxpayer, may choose whether

to determine the taxpayer's excess interest rate under paragraph (d)(5)(ii)(A) or (B) of this section and may select the published 30-day LIBOR rate.

(6) *Examples*. The following examples illustrate the rules of this section:

Example 1. Computation of interest expense; actual ratio. (i) *Facts*. (A) *FC* is a foreign corporation that is not a bank and that actively conducts a real estate business through a branch, *B*, in the United States. For the taxable year, *FC*'s balance sheet and income statement is as follows (assume amounts are in U.S. dollars and computed in accordance with paragraphs (b)(2) and (b)(3) of this section):

	Value	
Asset 1	$2,000	
Asset 2	2,500	
Asset 3	5,500	
	Amount	Interest Expense
Liability 1	$800	56
Liability 2	3,200	256
Capital	6,000	0

(B) Asset 1 is the stock of *FC*'s wholly-owned domestic subsidiary that is also actively engaged in the real estate business. Asset 2 is a building in the United States producing rental income that is entirely ECI to *FC*. Asset 3 is a building in the home country of *FC* that produces rental income. Liabilities 1 and 2 are loans that bear interest at the rates of 7% and 8%, respectively. Liability 1 is a booked liability of B, and Liability 2 is booked in *FC*'s home country. Assume that *FC* has not elected to use the fixed ratio in Step 2.

(ii) *Step 1*. Under paragraph (b)(1) of this section, Assets 1 and 3 are not U.S. assets, while Asset 2 qualifies as a U.S. asset. Thus, under paragraph (b)(3) of this section, the total value of U.S. assets for the taxable year is $2,500, the value of Asset 2.

(iii) *Step 2*. Under paragraph (c)(1) of this section, the amount of *FC*'s U.S.-connected liabilities for the taxable year is determined by multiplying $2,500 (the value of U.S. assets determined under Step 1) by the actual ratio for the taxable year. The actual ratio is the average amount of *FC*'s worldwide liabilities divided by the average value of *FC*'s worldwide assets. The amount of Liability 1 is $800, and the amount of Liability 2 is $3,200. Thus, the numerator of the actual ratio is $4,000. The average value of worldwide assets is $10,000 (Asset 1 + Asset 2 + Asset 3). The actual ratio, therefore, is 40% ($4,000/$10,000), and the amount of U.S.-connected liabilities for the taxable year is $1,000 ($2,500 U.S. assets × 40%).

(iv) *Step 3*. Because the amount of *FC*'s U.S.-connected liabilities ($1,000) exceeds the average total amount of U.S. booked liabilities of *B* ($800), *FC* determines its interest expense in accordance with paragraph (d)(5) of this section by adding the interest paid or accrued on U.S. booked liabilities, and the interest expense associated with the excess of its U.S.-connected liabilities over its average total amount of U.S. booked liabilities. Under paragraph (d)(5)(ii) of this section, *FC* determines the interest rate attributable to its excess U.S.-connected liabilities by dividing the interest expense paid or accrued by the average amount of U.S.-dollar denominated liabilities, which produces an interest rate of 8% ($256/$3200). Therefore, *FC*'s allocable interest expense is $72 ($56 of interest expense from U.S. booked liabilities plus $16 ($200 × 8%) of interest expense attributable to its excess U.S.-connected liabilities).

Example 2. Computation of interest expense; fixed ratio. (i) The facts are the same as in *Example 1*, except that *FC* makes a fixed ratio election under paragraph (c)(4) of this section. The conclusions under Step 1 are the same as in *Example 1*.

(ii) *Step 2*. Under paragraph (c)(1) of this section, the amount of U.S.-connected liabilities for the taxable year is determined by multiplying $2,500 (the value of U.S. assets determined under Step 1) by the fixed ratio for the taxable year, which, under paragraph (c)(4) of this section is 50 percent. Thus, the amount of U.S.-connected liabilities for the taxable year is $1,250 ($2,500 U.S. assets × 50%).

(iii) *Step 3*. As in *Example 1*, the amount of *FC*'s U.S.-connected liabilities exceed the average total amount of U.S. booked liabilities of *B*, requiring *FC* to determine its interest expense under paragraph (d)(5) of this section. In this case, however, *FC* has excess U.S.-connected liabilities of $450 ($1,250 of U.S.-connected liabilities—$800 U.S. booked liabilities). *FC* therefore has allocable interest expense of $92 ($56 of interest expense from U.S. booked liabilities plus $36 ($450 × 8%) of interest expense attributable to its excess U.S.-connected liabilities).

Example 3. Scaling ratio. (i) *Facts*. Bank *Z*, a resident of country *X*, has a branch in the United States through which it conducts its banking business. For the taxable year, *Z* has U.S.-connected liabilities, determined under paragraph (c) of this section, equal to $300. *Z*, however, has U.S. booked liabilities of $300 and *U*500. Therefore, assuming an exchange rate of the *U* to the U.S. dollar of 5:1, *Z* has U.S. booked liabilities of $400 ($300 + (*U*500 ÷ 5)).

(ii) *U.S.-connected liabilities*. Because *Z*'s U.S. booked liabilities of $400 exceed its U.S.-connected liabilities by $100, all of *Z*'s interest expense allocable to its U.S. trade or business must be scaled back pro-rata. To determine the scaling ratio, *Z* divides its U.S.-connected liabilities by its U.S. booked liabilities, as required by paragraph (d)(4) of this section. *Z*'s interest expense is scaled

back pro rata by the resulting ratio of ¾ ($300 ÷ $400). *Z*'s income, expense, gain or loss from hedging transactions described in paragraph (d)(2)(vi) of this section must be similarly reduced.

Example 4. [Reserved]

Example 5. U.S. booked liabilities—direct relationship. (i) *Facts.* Bank A, a resident of Country X maintains a banking office in the U.S. that records transactions on three sets of books for State A, an International Banking Facility (IBF) for its bank regulatory approved international transactions, and a shell branch licensed operation in Country C. Bank A records substantial ECI assets from its bank lending and placement activities and a mix of interbranch and non-ECI producing assets from the same or similar activities on the books of State A branch and on its IBF. Bank A's Country C branch borrows substantially from third parties, as well as from its home office, and lends all of its funding to its State A branch and IBF to fund the mix of ECI, interbranch and non-ECI activities on those two books. The consolidated books of State A branch and IBF indicate that a substantial amount of the total book assets constitute U.S. assets under paragraph (b) of this section. Some of the third-party borrowings on the books of the State A branch are used to lend directly to Bank A's home office in Country X. These borrowings reflect the average borrowing rate of the State A branch, IBF and Country C branches as a whole. All third-party borrowings reflected on the books of State A branch, the IBF and Country C branch were recorded on such books before the close of business on the day the liabilities were acquired by Bank A.

(ii) *U.S. booked liabilities.* The facts demonstrate that the separate State A branch, IBF and Country C branch books taken together, constitute a set of books within the meaning of paragraph (d)(2)(iii)(A)(*1*) of this section. Such set of books as a whole has a direct relationship to an ECI activity under paragraph (d)(2)(iii)(A)(*2*) of this section even though the Country C branch books standing alone would not. The third-party liabilities recorded on the books of Country C constitute U.S. booked liabilities because they were timely recorded and the overall set of books on which they were reflected has a direct relationship to a bank lending and interbank placement ECI producing activity. The third-party liabilities that were recorded on the books of State A branch that were used to lend funds to Bank A's home office also constitute U.S. booked liabilities because the interbranch activity the funds were used for is a lending activity of a type that also gives rise to a substantial amount of ECI that is properly reflected on the same set of books as the interbranch loans. Accordingly, the liabilities are not traced to their specific interbranch use but to the overall activity of bank lending and interbank placements which gives rise to substantial ECI. The facts show that the liabilities were not acquired to increase artificially the interest expense of Bank A's U.S. booked liabilities as a whole under paragraph (d)(2)(v) of this section. The third-party liabilities also constitute U.S. booked liabilities for purposes of determining Bank A's branch interest under §1.884–4(b)(1)(i)(A) regardless of whether Bank A uses the Adjusted U.S. booked liability method, or the Separate Currency Pool method to allocate its interest expense under paragraph 5(e) of this section.

(e) *Separate currency pools method*—(1) *General rule.* If a foreign corporation elects to use the method in this paragraph, its total interest expense allocable to ECI is the sum of the separate interest deductions for each of the currencies in which the foreign corporation has U.S. assets. The separate interest deductions are determined under the following three-step process.

(i) *Determine the value of U.S. assets in each currency pool.* First, the foreign corporation must determine the amount of its U.S. assets, using the methodology in paragraph (b) of this section, in each currency pool. The foreign corporation may convert into U.S. dollars any currency pool in which the foreign corporation holds less than 3% of its U.S. assets. A transaction (or transactions) that hedges a U.S. asset shall be taken into account for purposes of determining the currency denomination and the value of the U.S. asset.

(ii) *Determine the U.S.-connected liabilities in each currency pool.* Second, the foreign corporation must determine the amount of its U.S.-connected liabilities in each currency pool by multiplying the amount of U.S. assets (as determined under paragraph (b)(3) of this section) in the currency pool by the foreign corporation's actual ratio (as determined under paragraph (c)(2) of this section) for the taxable year or, if the taxpayer has made an election in accordance with paragraph (c)(4) of this section, by the fixed ratio.

(iii) *Determine the interest expense attributable to each currency pool.* Third, the foreign corporation must determine the interest expense attributable to each currency pool by multiplying the U.S.-connected liabilities in each

currency pool by the prescribed interest rate as defined in paragraph (e)(2) of this section.

(2) *Prescribed interest rate.* For each currency pool, the prescribed interest rate is determined by dividing the total interest expense that is paid or accrued for the taxable year with respect to the foreign corporation's worldwide liabilities denominated in that currency, by the foreign corporation's average worldwide liabilities (whether interest bearing or not) denominated in that currency. The interest expense and liabilities are to be stated in that currency.

(3) *Hedging transactions.* [Reserved]

(4) *Election not available if excessive hyperinflationary assets.* The election to use the separate currency pools method of this paragraph (e) is not available if the value of the foreign corporation's U.S. assets denominated in a hyperinflationary currency, as defined in §1.985–1, exceeds ten percent of the value of the foreign corporation's total U.S. assets. If a foreign corporation made a valid election to use the separate currency pools method in a prior year but no longer qualifies to use such method pursuant to this paragraph (e)(4), the taxpayer must use the method provided by paragraphs (b) through (d) of this section.

(5) *Examples.* The separate currency pools method of this paragraph (e) is illustrated by the following examples:

Example 1. Separate currency pools method—(i) *Facts.* (A) Bank *Z*, a resident of country *X*, has a branch in the United States through which it conducts its banking business. For its 1997 taxable year, *Z* has U.S. assets, as defined in paragraph (b) of this section, that are denominated in U.S. dollars and in *U*, the country *X* currency. Accordingly, *Z*'s U.S. assets are as follows:

	Average value
U.S. Dollar Assets	$20,000
U Assets	*U* 5,000

(B) *Z*'s worldwide liabilities are also denominated in U.S. Dollars and in *U*. The average interest rates on *Z*'s worldwide liabilities, including those in the United States, are 6% on its U.S. dollar liabilities, and 12% on its liabilities denominated in *U*. Assume that *Z* has properly elected to use its actual ratio of 95% to determine its U.S.-connected liabilities in Step 2, and has also properly elected to use the separate currency pools method provided in paragraph (e) of this section.

(ii) *Determination of interest expense.* *Z* determines the interest expense attributable to its U.S.-connected liabilities according to the steps described below.

(A) First, *Z* separates its U.S. assets into two currency pools, one denominated in U.S. dollars ($20,000) and the other denominated in *U* (*U*5,000).

(B) Second, *Z* multiplies each pool of assets by the applicable ratio of worldwide liabilities to assets, which in this case is 95%. Thus, Z has U.S.-connected liabilities of $19,000 ($20,000 × 95%), and *U*4750 (*U*5000 × 95%).

(C) Third, *Z* calculates its interest expense by multiplying each pool of its U.S.-connected liabilities by the relevant interest rates. Accordingly, *Z*'s allocable interest expense for the year is $1140 ($19,000 × 6%), the sum of the expense associated with its U.S. dollar liabilities, plus *U*570 (*U*4750 × 12%), the interest expense associated with its liabilities denominated in *U*. *Z* must translate its interest expense denominated in *U* in accordance with the rules provided in section 988, and then must determine whether it is subject to any other provision of the Code that would disallow or defer any portion of its interest expense so determined.

Example 2. [Reserved]

(f)(1) *Effective/applicability date* (1) This section is applicable for taxable years ending on or after August 15, 2009. A taxpayer, however, may choose to apply §1.882–5T, rather than applying the final regulations, for any taxable year beginning on or after August 16, 2008 but before August 15, 2009.

(2) *Special rules for financial products.* [Reserved]

[T.D. 8658, 61 FR 9329, Mar. 8, 1996; 61 FR 15891, Apr. 10, 1996, as amended by T.D. 9281, 71 FR 47448, Aug. 17, 2006; 71 FR 56868, Sept. 28, 2006; T.D. 9465, 74 FR 49320, Sept. 28, 2009; 74 FR 57252, Nov. 5, 2009]

§ 1.883–0 Outline of major topics.

This section lists the major paragraphs contained in §§1.883–1 through 1.883–5.

§ 1.883–1 Exclusion of income from the international operation of ships or aircraft.

(a) General rule.
(b) Qualified income.
(c) Qualified foreign corporation.
(1) General rule.
(2) Stock ownership test.
(3) Substantiation and reporting requirements.

(i) General rule.
(ii) Further documentation.
(A) General rule.
(B) Names and permanent addresses of certain shareholders.
(4) Commissioner's discretion to cure defects in documentation.
(d) Qualified foreign country.
(e) Operation of ships or aircraft.
(1) General rule.
(2) Pool, partnership, strategic alliance, joint operating agreement, code-sharing arrangement or other joint venture.
(3) Activities not considered operation of ships or aircraft.
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(5) Definitions.
(i) Bareboat charter.
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(viii) Space or slot charter.
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(f) International operation of ships or aircraft.
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(B) Round trip travel on ships.
(ii) International carriage of cargo.
(iii) Bareboat charter of ships or dry lease of aircraft used in international operation of ships or aircraft.
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(g) Activities incidental to the international operation of ships or aircraft.
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(3) Other Services. [Reserved]
(4) Activities involved in a pool, partnership, strategic alliance, joint operating agreement, code-sharing arrangement or other joint venture.
(h) Equivalent exemption.
(1) General rule.
(2) Determining equivalent exemptions for each category of income.
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(A) General rule.
(B) Special rule for claiming simultaneous benefits under section 883 and an income tax convention.
(iii) Participation in certain joint ventures.
(iv) Independent interpretation of income tax conventions.
(4) Exemptions not qualifying as equivalent exemptions.
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(ii) Reduced tax rate or time limited exemption.
(iii) Inbound or outbound freight tax.
(iv) Exemptions for limited types of cargo.
(v) Territorial tax systems.
(vi) Countries that tax on a residence basis.
(vii) Exemptions within categories of income.
(i) Treatment of possessions.
(j) Expenses related to qualified income.

§ 1.883–2 Treatment of publicly-traded corporations.

(a) General rule.
(b) Established securities market.
(1) General rule.
(2) Exchanges with multiple tiers.
(3) Computation of dollar value of stock traded.
(4) Over-the-counter market.
(5) Discretion to determine that an exchange does not qualify as an established securities market.
(c) Primarily traded.
(d) Regularly traded.
(1) General rule.
(2) Classes of stock traded on a domestic established securities market treated as meeting trading requirements.
(3) Closely-held classes of stock not treated as meeting trading requirements.
(i) General rule.
(ii) Exception.
(iii) Five-percent shareholders.
(A) Related persons.
(B) Investment companies.
(4) Anti-abuse rule.
(5) Example.
(e) Substantiation that a foreign corporation is publicly traded.
(1) General rule.
(2) Availability and retention of documents for inspection.
(f) Reporting requirements.

§ 1.883–3 Treatment of controlled foreign corporations.

(a) General rule.
(b) Qualified U.S. person ownership test.
(1) General rule.
(2) Qualified U.S. person.
(3) Treatment of bearer shares.
(4) Ownership attribution through certain domestic entities.
(5) Examples.

(c) Substantiation of CFC stock ownership.
(1) In general.
(2) Ownership statements from qualified U.S. persons.
(3) Ownership statements from intermediaries.
(4) Three-year period of validity.
(5) Availability and retention of documents for inspection.
(d) Reporting requirements.

§ 1.883–4 Qualified shareholder stock ownership test.

(a) General rule.
(b) Qualified shareholder.
(1) General rule.
(2) Residence of individual shareholders.
(i) General rule.
(ii) Tax home.
(3) Certain income tax convention restrictions applied to shareholders.
(4) Not-for-profit organizations.
(5) Pension funds.
(i) Pension fund defined.
(ii) Government pension funds.
(iii) Nongovernment pension funds.
(iv) Beneficiary of a pension fund.
(c) Rules for determining constructive ownership.
(1) General rules for attribution.
(2) Partnerships.
(i) General rule.
(ii) Partners resident in the same country.
(iii) Examples.
(3) Trusts and estates.
(i) Beneficiaries.
(ii) Grantor trusts.
(4) Corporations that issue stock.
(5) Taxable nonstock corporations.
(6) Mutual insurance companies and similar entities.
(7) Computation of beneficial interests in nongovernment pension funds.
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(1) General rule.
(2) Application of general rule.
(i) Ownership statements.
(ii) Three-year period of validity.
(3) Special rules.
(i) Substantiating residence of certain shareholders.
(ii) Special rule for registered shareholders owning less than one percent of widely-held corporations.
(iii) Special rule for beneficiaries of pension funds.
(A) Government pension fund.
(B) Nongovernment pension fund.
(iv) Special rule for stock owned by publicly-traded corporations.
(v) Special rule for not-for-profit organizations.
(vi) Special rule for a foreign airline covered by an air services agreement.
(vii) Special rule for taxable nonstock corporations.
(viii) Special rule for closely-held corporations traded in the United States.
(4) Ownership statements from shareholders.
(i) Ownership statements from individuals.
(ii) Ownership statements from foreign governments.
(iii) Ownership statements from publicly-traded corporate shareholders.
(iv) Ownership statements from not-for-profit organizations.
(v) Ownership statements from intermediaries.
(A) General rule.
(B) Ownership statements from widely-held intermediaries with registered shareholders owning less than one percent of such widely-held intermediary.
(C) Ownership statements from pension funds.
(*1*) Ownership statements from government pension funds.
(*2*) Ownership statements from nongovernment pension funds.
(*3*) Time for making determinations.
(D) Ownership statements from taxable nonstock corporations.
(5) Availability and retention of documents for inspection.
(e) Reporting requirements.

§ 1.883–5 Effective dates.

(a) General rule.
(b) Election for retroactive application.
(c) Transitional information reporting rule.
(d) Effective/applicability dates.

[T.D. 9087, 68 FR 51399, Aug. 26, 2003, as amended by T.D. 9332, 72 FR 34604, June 25, 2007; T.D. 9502, 75 FR 56861, Sept. 17, 2010]

§ 1.883–1 Exclusion of income from the international operation of ships or aircraft.

(a) *General rule.* Qualified income derived by a qualified foreign corporation from its international operation of ships or aircraft is excluded from gross income and exempt from United States Federal income tax. Paragraph (b) of this section defines the term *qualified income.* Paragraph (c) of this section defines the term *qualified foreign corporation.* Paragraph (f) of this section defines the term *international operation of ships or aircraft.*

(b) *Qualified income.* Qualified income is income derived from the international operation of ships or aircraft that—

(1) Is properly includible in any of the income categories described in paragraph (h)(2) of this section; and

(2) Is the subject of an equivalent exemption, as defined in paragraph (h) of this section, granted by the qualified foreign country, as defined in paragraph (d) of this section, in which the foreign corporation seeking qualified foreign corporation status is organized.

(c) *Qualified foreign corporation*—(1) *General rule*. A qualified foreign corporation is a corporation that is organized in a qualified foreign country and considered engaged in the international operation of ships or aircraft. The term *corporation* is defined in section 7701(a)(3) and the regulations thereunder. Paragraph (d) of this section defines the term *qualified foreign country*. Paragraph (e) of this section defines the term *operation of ships or aircraft*, and paragraph (f) of this section defines the term *international operation of ships or aircraft*. To be a qualified foreign corporation, the corporation must satisfy the stock ownership test of paragraph (c)(2) of this section and satisfy the substantiation and reporting requirements described in paragraph (c)(3) of this section. A corporation may be a qualified foreign corporation with respect to one category of qualified income but not with respect to another such category. See paragraph (h)(2) of this section for a discussion of the categories of qualified income.

(2) *Stock ownership test*. To be a qualified foreign corporation, a foreign corporation must satisfy the publicly-traded test of §1.883–2(a), the CFC stock ownership test of §1.883–3(a), or the qualified shareholder stock ownership test of §1.883–4(a).

(3) *Substantiation and reporting requirements*—(i) *General rule*. To be a qualified foreign corporation, a foreign corporation must include the following information in its Form 1120-F, ''U.S. Income Tax Return of a Foreign Corporation,'' in the manner prescribed by such form and its accompanying instructions—

(A) The corporation's name and address (including mailing code);

(B) The corporation's U.S. taxpayer identification number;

(C) The foreign country in which the corporation is organized;

(D) The applicable authority for an equivalent exemption, for example, the citation of a statute in the country where the corporation is organized, a diplomatic note between the United States and such country, or an income tax convention between the United States and such country in the case of a corporation described in paragraphs (h)(3)(i), (ii) and (iii) of this section;

(E) The category or categories of qualified income for which an exemption is being claimed;

(F) A reasonable estimate of the gross amount of income in each category of qualified income for which the exemption is claimed, to the extent such amounts are readily determinable;

(G) A statement as to whether any shares of the foreign corporation or of any intermediary corporation that are relied on to satisfy any stock ownership test described in paragraph (c)(2) of this section are issued in bearer form and whether the bearer shares are maintained in a dematerialized book-entry system in which the bearer shares are represented only by book entries and no physical certificates are issued or transferred, or in an immobilized book-entry system in which evidence of ownership is maintained on the books and records of the corporate issuer or by a broker or financial institution;

(H) Any other information required under §1.883–2(f), §1.883–3(d), or §1.883–4(e), as applicable; and

(I) Any other relevant information specified in Form 1120–F, ''U.S. Income Tax Return of a Foreign Corporation,'' and its accompanying instructions.

(ii) *Further documentation*—(A) *General rule*. Except as provided in paragraph (c)(3)(ii)(B) of this section, if the Commissioner requests in writing that the foreign corporation provide documentation or substantiate any representations made under paragraph (c)(3)(i) of this section, or under §1.883–2(f), §1.883–3(d), or §1.883–4(e), as applicable, the foreign corporation must provide the requested documentation or substantiation within 60 days of receiving the written request. If the foreign corporation does not provide the requested documentation or substantiation within the 60-day period, but demonstrates that the failure was due

to reasonable cause and not willful neglect, the Commissioner may grant the foreign corporation a 30-day extension to provide the requested documentation or substantiation. Whether a failure to provide the documentation or substantiation in a timely manner was due to reasonable cause and not willful neglect shall be determined by the Commissioner based on all the facts and circumstances.

(B) *Names and permanent addresses of certain shareholders.* If the Commissioner requests the names and permanent addresses of individual qualified shareholders of a foreign corporation, as represented on each individual's ownership statement, to substantiate the requirements of the exception to the closely-held test in the publicly-traded test in §1.883–2(e), the qualified shareholder stock ownership test in §1.883–4(a), or the qualified U.S. person ownership test in §1.883–3(b), the foreign corporation must provide the requested information within 30 days of receiving the written request. If the foreign corporation does not provide the requested information within the 30-day period, but demonstrates that the failure was due to reasonable cause and not willful neglect, the Commissioner may grant the foreign corporation a 30-day extension to provide the requested information. Whether a failure to provide the requested information was due to reasonable cause and not willful neglect shall be determined by the Commissioner based on all the facts and circumstances.

(d) *Qualified foreign country.* A qualified foreign country is a foreign country that grants to corporations organized in the United States an equivalent exemption, as described in paragraph (h) of this section, for the category of qualified income, as described in paragraph (h)(2) of this section, derived by the foreign corporation seeking qualified foreign corporation status. A foreign country may be a qualified foreign country with respect to one category of qualified income but not with respect to another such category.

(e) *Operation of ships or aircraft*—(1) *General rule.* Except as provided in paragraph (e)(2) of this section, a foreign corporation is considered engaged in the operation of ships or aircraft only during the time it is an owner or lessee of one or more entire ships or aircraft and uses such ships or aircraft in one or more of the following activities—

(i) Carriage of passengers or cargo for hire;

(ii) In the case of a ship, the leasing out of the ship under a time or voyage charter (full charter), space or slot charter, or bareboat charter, as those terms are defined in paragraph (e)(5) of this section, provided the ship is used to carry passengers or cargo for hire; and

(iii) In the case of aircraft, the leasing out of the aircraft under a wet lease (full charter), space, slot, or block-seat charter, or dry lease, as those terms are defined in paragraph (e)(5) of this section, provided the aircraft is used to carry passengers or cargo for hire.

(2) *Pool, partnership, strategic alliance, joint operating agreement, code-sharing arrangement or other joint venture.* A foreign corporation is considered engaged in the operation of ships or aircraft within the meaning of paragraph (e)(1) of this section with respect to its participation in a pool, partnership, strategic alliance, joint operating agreement, code-sharing arrangement or other joint venture if it directly, or indirectly through one or more fiscally transparent entities under the income tax laws of the United States, as defined in paragraph (e)(5)(v) of this section—

(i) Owns an interest in a partnership, disregarded entity, or other fiscally transparent entity under the income tax laws of the United States that itself would be considered engaged in the operation of ships or aircraft under paragraph (e)(1) of this section if it were a foreign corporation; or

(ii) Participates in a pool, strategic alliance, joint operating agreement, code-sharing arrangement, or other joint venture that is not an entity, as defined in paragraph (e)(5)(iv) of this section, involving one or more activities described in paragraphs (e)(1)(i) through (iii) of this section, but only if—

(A) In the case of a direct interest, the foreign corporation is otherwise engaged in the operation of ships or aircraft under paragraph (e)(1) of this section; or

(B) In the case of an indirect interest, either the foreign corporation is otherwise engaged, or one of the fiscally transparent entities would be considered engaged if it were a foreign corporation, in the operation of ships or aircraft under paragraph (e)(1) of this section.

(3) *Activities not considered operation of ships or aircraft.* Activities that do not constitute operation of ships or aircraft include, but are not limited to—

(i) The activities of a nonvessel operating common carrier, as defined in paragraph (e)(5)(vii) of this section;

(ii) Ship or aircraft management;

(iii) Obtaining crews for ships or aircraft operated by another party;

(iv) Acting as a ship's agent;

(v) Ship or aircraft brokering;

(vi) Freight forwarding;

(vii) The activities of travel agents and tour operators;

(viii) Rental by a container leasing company of containers and related equipment; and

(ix) The activities of a concessionaire.

(4) *Examples.* The rules of paragraphs (e)(1) through (3) of this section are illustrated by the following examples:

Example 1. Three tiers of charters—(i) *Facts.* A, B, and C are foreign corporations. A purchases a ship. A and B enter into a bareboat charter of the ship for a term of 20 years, and B, in turn, enters into a time charter of the ship with C for a term of 5 years. Under the time charter, B is responsible for the complete operation of the ship, including providing the crew and maintenance. C uses the ship during the term of the time charter to carry its customers' freight between U.S. and foreign ports. C owns no ships.

(ii) *Analysis.* Because A is the owner of the entire ship and leases out the ship under a bareboat charter to B, and because the sublessor, C, uses the ship to carry cargo for hire, A is considered engaged in the operation of a ship under paragraph (e)(1) of this section during the term of the time charter. B leases in the entire ship from A and leases out the ship under a time charter to C, who uses the ship to carry cargo for hire. Therefore, B is considered engaged in the operation of a ship under paragraph (e)(1) of this section during the term of the time charter. C time charters the entire ship from B and uses the ship to carry its customers' freight during the term of the charter. Therefore, C is also engaged in the operation of a ship under paragraph (e)(1) of this section during the term of the time charter.

Example 2. Partnership with contributed shipping assets—(i) *Facts.* X, Y, and Z, each a foreign corporation, enter into a partnership, P. P is a fiscally transparent entity under the income tax laws of the United States, as defined in paragraph (e)(5)(v) of this section. Under the terms of the partnership agreement, each partner contributes all of the ships in its fleet to P in exchange for interests in the partnership and shares in the P profits from the international carriage of cargo. The partners share in the overall management of P, but each partner, acting in its capacity as partner, continues to crew and manage all ships previously in its fleet.

(ii) *Analysis.* P owns the ships contributed by the partners and uses these ships to carry cargo for hire. Therefore, if P were a foreign corporation, it would be considered engaged in the operation of ships within the meaning of paragraph (e)(1) of this section. Accordingly, because P is a fiscally transparent entity under the income tax laws of the United States, as defined in paragraph (e)(5)(v) of this section, X, Y, and Z are each considered engaged in the operation of ships through P, within the meaning of paragraph (e)(2)(i) of this section, with respect to their distributive share of income from P's international carriage of cargo.

Example 3. Joint venture with chartered in ships—(i) *Facts.* Foreign corporation A owns a number of foreign subsidiaries involved in various aspects of the shipping business, including S1, S2, S3, and S4. S4 is a foreign corporation that provides cruises but does not own any ships. S1, S2, and S3 are foreign corporations that own cruise ships. S1, S2, S3, and S4 form joint venture JV, in which they are all interest holders, to conduct cruises. JV is a fiscally transparent entity under the income tax laws of the United States, as defined in paragraph (e)(5)(v) of this section. Under the terms of the joint venture, S1, S2, and S3 each enter into time charter agreements with JV, pursuant to which S1, S2, and S3 retain control of the navigation and management of the individual ships, and JV will use the ships to carry passengers for hire. The overall management of the cruise line will be provided by S4.

(ii) *Analysis.* S1, S2, and S3 each owns ships and time charters those ships to JV, which uses the ships to carry passengers for hire. Accordingly, S1, S2, and S3 are each considered engaged in the operation of ships under paragraph (e)(1) of this section. JV leases in entire ships by means of the time charters, and JV uses those ships to carry passengers on cruises. Thus, JV would be engaged in the operation of ships within the meaning of

paragraph (e)(1) of this section if it were a foreign corporation. Therefore, although S4 does not directly own or lease in a ship, S4 also is engaged in the operation of ships, within the meaning of paragraph (e)(2)(i) of this section, with respect to its participation in JV.

Example 4. Tiered partnerships—(i) *Facts.* Foreign corporations A, B, and C enter into a partnership, P1. P1 is one of several shareholders of Poolco, a foreign limited liability company that makes an election pursuant to § 301.7701–3 of this chapter to be treated as a partnership for U.S. tax purposes. P1 acquires several ships and time charters them out to Poolco. Poolco slot or voyage charters such ships out to third parties for use in the carriage of cargo for hire. P1 and Poolco are fiscally transparent entities under the income tax laws of the United States, as defined in paragraph (e)(5)(v) of this section.

(ii) *Analysis.* A, B, and C are considered engaged in the operation of ships under paragraph (e)(2)(i) of this section with respect to their direct interest in P1 and with respect to their indirect interest in Poolco because both P1 and Poolco are fiscally transparent entities under the income tax laws of the United States and would be considered engaged in the operation of ships under paragraph (e)(1) of this section if they were foreign corporations. The result would be the same if Poolco were a single-member disregarded entity owned solely by P1.

(5) *Definitions*—(i) *Bareboat charter.* A bareboat charter is a contract for the use of a ship or aircraft whereby the lessee is in complete possession, control, and command of the ship or aircraft. For example, in a bareboat charter, the lessee is responsible for the navigation and management of the ship or aircraft, the crew, supplies, repairs and maintenance, fees, insurance, charges, commissions and other expenses connected with the use of the ship or aircraft. The lessor of the ship bears none of the expense or responsibility of operation of the ship or aircraft.

(ii) *Code-sharing arrangement.* A code-sharing arrangement is an arrangement in which one air carrier puts its identification code on the flight of another carrier. This arrangement allows the first carrier to hold itself out as providing service in markets where it does not otherwise operate or where it operates infrequently. Code-sharing arrangements can range from a very limited agreement between two carriers involving only one market to agreements involving multiple markets and alliances between or among international carriers which also include joint marketing, baggage handling, one-stop check-in service, sharing of frequent flyer awards, and other services. For rules involving the sale of code-sharing tickets, see paragraph (g)(1)(vi) of this section.

(iii) *Dry lease.* A dry lease is the bareboat charter of an aircraft.

(iv) *Entity.* For purposes of this paragraph (e), an entity is any person that is treated by the United States as other than an individual for U.S. Federal income tax purposes. The term includes disregarded entities.

(v) *Fiscally transparent entity under the income tax laws of the United States.* For purposes of this paragraph (e), an entity is fiscally transparent under the income tax laws of the United States if the entity would be considered fiscally transparent under the income tax laws of the United States under the principles of § 1.894–1(d)(3).

(vi) *Full charter.* Full charter (or full rental) means a time charter or a voyage charter of a ship or a wet lease of an aircraft but during which the full crew and management are provided by the lessor.

(vii) *Nonvessel operating common carrier.* A nonvessel operating common carrier is an entity that does not exercise control over any part of a vessel, but holds itself out to the public as providing transportation for hire, issues bills of lading, assumes responsibility or is liable by law as a common carrier for safe transportation of shipments, and arranges in its own name with other common carriers, including those engaged in the operation of ships, for the performance of such transportation.

(viii) *Space or slot charter.* A space or slot charter is a contract for use of a certain amount of space (but less than all of the space) on a ship or aircraft, and may be on a time or voyage basis. When used in connection with passenger aircraft this sort of charter may be referred to as the sale of block seats.

(ix) *Time charter.* A time charter is a contract for the use of a ship or aircraft for a specific period of time, during which the lessor of the ship or aircraft retains control of the navigation and management of the ship or aircraft

(*i.e.*, the lessor continues to be responsible for the crew, supplies, repairs and maintenance, fees and insurance, charges, commissions and other expenses connected with the use of the ship or aircraft).

(x) *Voyage charter*. A voyage charter is a contract similar to a time charter except that the ship or aircraft is chartered for a specific voyage or flight rather than for a specific period of time.

(xi) *Wet lease*. A wet lease is the time or voyage charter of an aircraft.

(f) *International operation of ships or aircraft*—(1) *General rule*. The term *international operation of ships or aircraft* means the operation of ships or aircraft, as defined in paragraph (e) of this section, with respect to the carriage of passengers or cargo on voyages or flights that begin or end in the United States, as determined under paragraph (f)(2) of this section. The term does not include the carriage of passengers or cargo on a voyage or flight that begins and ends in the United States, even if the voyage or flight contains a segment extending beyond the territorial limits of the United States, unless the passenger disembarks or the cargo is unloaded outside the United States. Operation of ships or aircraft beyond the territorial limits of the United States does not constitute in itself international operation of ships or aircraft.

(2) *Determining whether income is derived from international operation of ships or aircraft*. Whether income is derived from international operation of ships or aircraft is determined on a passenger by passenger basis (as provided in paragraph (f)(2)(i) of this section) and on an item-of-cargo by item-of-cargo basis (as provided in paragraph (f)(2)(ii) of this section). In the case of the bareboat charter of a ship or the dry lease of an aircraft, whether the charter income for a particular period is derived from international operation of ships or aircraft is determined by reference to how the ship or aircraft is used by the lowest-tier lessee in the chain of lessees (as provided in paragraph (f)(2)(iii) of this section).

(i) *International carriage of passengers*—(A) *General rule*. Except in the case of a round trip described in paragraph (f)(2)(i)(B) of this section, income derived from the carriage of a passenger will be income from international operation of ships or aircraft if the passenger is carried between a beginning point in the United States and an ending point outside the United States, or vice versa. Carriage of a passenger will be treated as ending at the passenger's final destination even if, en route to the passenger's final destination, a stop is made at an intermediate point for refueling, maintenance, or other business reasons, provided the passenger does not change ships or aircraft at the intermediate point. Similarly, carriage of a passenger will be treated as beginning at the passenger's point of origin even if, en route to the passenger's final destination, a stop is made at an intermediate point, provided the passenger does not change ships or aircraft at the intermediate point. Carriage of a passenger will be treated as beginning or ending at a U.S. or foreign intermediate point if the passenger changes ships or aircraft at that intermediate point. Income derived from the sale of a ticket for international carriage of a passenger will be treated as income derived from international operation of ships or aircraft even if the passenger does not begin or complete an international journey because of unanticipated circumstances.

(B) *Round trip travel on ships*. In the case of income from the carriage of a passenger on a ship that begins its voyage in the United States, calls on one or more foreign intermediate ports, and returns to the same or another U.S. port, such income from carriage of a passenger on the entire voyage will be treated as income derived from international operation of ships or aircraft under paragraph (f)(2)(i)(A) of this section. This result obtains even if such carriage includes one or more intermediate stops at a U.S. port or ports and even if the passenger does not disembark at the foreign intermediate point.

(ii) *International carriage of cargo*. Income from the carriage of cargo will be income derived from international operation of ships or aircraft if the cargo is carried between a beginning point in the United States and an ending point

outside the United States, or vice versa. Carriage of cargo will be treated as ending at the final destination of the cargo even if, en route to that final destination, a stop is made at a U.S. intermediate point, provided the cargo is transported to its ultimate destination on the same ship or aircraft. If the cargo is transferred to another ship or aircraft, the carriage of the cargo may nevertheless be treated as ending at its final destination, if the same taxpayer transports the cargo to and from the U.S. intermediate point and the cargo does not pass through customs at the U.S. intermediate point. Similarly, carriage of cargo will be treated as beginning at the cargo's point of origin, even if en route to its final destination a stop is made at a U.S. intermediate point, provided the cargo is transported to its ultimate destination on the same ship or aircraft. If the cargo is transferred to another ship or aircraft at the U.S. intermediate point, the carriage of the cargo may nevertheless be treated as beginning at the point of origin, if the same taxpayer transports the cargo to and from the U.S. intermediate point and the cargo does not pass through customs at the U.S. intermediate point. Repackaging, recontainerization, or any other activity involving the unloading of the cargo at the U.S. intermediate point does not change these results, provided the same taxpayer transports the cargo to and from the U.S. intermediate point and the cargo does not pass through customs at the U.S. intermediate point. A lighter vessel that carries cargo to, or picks up cargo from, a vessel located beyond the territorial limits of the United States and correspondingly loads or unloads that cargo at a U.S. port, carries cargo between a point in the United States and a point outside the United States. However, a lighter vessel that carries cargo to, or picks up cargo from, a vessel located within the territorial limits of the United States, and correspondingly loads or unloads that cargo at a U.S. port, is not engaged in international operation of ships or aircraft. Income from the carriage of military cargo on a voyage that begins in the United States, stops at a foreign intermediate port or a military prepositioning location, and returns to the same or another U.S. port without unloading its cargo at the foreign intermediate point, will nevertheless be treated as derived from international operation of ships or aircraft.

(iii) *Bareboat charter of ships or dry lease of aircraft used in international operation of ships or aircraft.* If a qualified foreign corporation bareboat charters a ship or dry leases an aircraft to a lessee, and the lowest tier lessee in the chain of ownership uses such ship or aircraft for the international carriage of passengers or cargo for hire, as described in paragraphs (f)(2)(i) and (ii) of this section, then the amount of charter income attributable to the period the ship or aircraft is used by the lowest tier lessee is income from international operation of ships or aircraft. The foreign corporation generally must determine the amount of the charter income that is attributable to such international operation of ships or aircraft by multiplying the amount of charter income by a fraction, the numerator of which is the total number of days of uninterrupted travel on voyages or flights of such ship or aircraft between the United States and the farthest point or points where cargo or passengers are loaded en route to, or discharged en route from, the United States during the smaller of the taxable year or the particular charter period, and the denominator of which is the total number of days in the smaller of the taxable year or the particular charter period. For this purpose, the number of days during which the ship or aircraft is not generating transportation income, within the meaning of section 863(c)(2), are not included in the numerator or denominator of the fraction. However, the foreign corporation may adopt an alternative method for determining the amount of the charter income that is attributable to the international operation of ships or aircraft if it can establish that the alternative method more accurately reflects the amount of such income.

(iv) *Charter of ships or aircraft for hire.* For purposes of this section, if a foreign corporation time, voyage, or bareboat charters out a ship or aircraft, and the lowest-tier lessee uses the ship or aircraft to carry passengers

or cargo on a fee basis, the ship or aircraft is considered used to carry passengers or cargo for hire, regardless of whether the ship or aircraft may be empty during a portion of the charter period due to a backhaul voyage or flight or for purposes of repositioning. If a foreign corporation time, voyage, or bareboat charters out a ship or aircraft, and the lowest-tier lessee uses the ship or aircraft for the carriage of proprietary goods, including an empty backhaul voyage or flight or repositioning related to such carriage of proprietary goods, the ship or aircraft similarly will be treated as used to carry cargo for hire.

(g) *Activities incidental to the international operation of ships or aircraft*—(1) *General rule*. Certain activities of a foreign corporation engaged in the international operation of ships or aircraft are so closely related to the international operation of ships or aircraft that they are considered incidental to such operation, and income derived by the foreign corporation from its performance of these incidental activities is deemed to be income derived from the international operation of ships or aircraft. Examples of such activities include—

(i) Temporary investment of working capital funds to be used in the international operation of ships or aircraft by the foreign corporation;

(ii) Sale of tickets by the foreign corporation engaged in the international operation of ships for the international carriage of passengers by ship on behalf of another corporation engaged in the international operation of ships;

(iii) Sale of tickets by the foreign corporation engaged in the international operation of aircraft for the international carriage of passengers by air on behalf of another corporation engaged in the international operation of aircraft;

(iv) Contracting with concessionaires for performance of services onboard during the international operation of the foreign corporation's ships or aircraft;

(v) Providing (either by subcontracting or otherwise) for the carriage of cargo preceding or following the international carriage of cargo under a through bill of lading, airway bill or similar document through a related corporation or through an unrelated person (and the rules of section 267(b) shall apply for purposes of determining whether a corporation or other person is related to the foreign corporation);

(vi) To the extent not described in paragraph (g)(1)(iii) of this section, the sale or issuance by the foreign corporation engaged in the international operation of aircraft of intraline, interline, or code-sharing tickets for the carriage of persons by air between a U.S. gateway and another U.S. city preceding or following international carriage of passengers, provided that all such flight segments are provided pursuant to the passenger's original invoice, ticket or itinerary and in the case of intraline tickets are a part of uninterrupted international air transportation (within the meaning of section 4262(c)(3));

(vii) Arranging for port city hotel accommodations within the United States for a passenger for the one night before or after the international carriage of that passenger by the foreign corporation engaged in the international operation of ships;

(viii) Bareboat charter of ships or dry lease of aircraft normally used by the foreign corporation in international operation of ships or aircraft but currently not needed, if the ship or aircraft is used by the lessee for international carriage of cargo or passengers;

(ix) Arranging by means of a space or slot charter for the carriage of cargo listed on a bill of lading or airway bill or similar document issued by the foreign corporation on the ship or aircraft of another corporation engaged in the international operation of ships or aircraft;

(x) The provision of containers and related equipment by the foreign corporation in connection with the international carriage of cargo for use by its customers, including short-term use within the United States immediately preceding or following the international carriage of cargo (for this purpose, a period of five days or less shall be presumed to be short-term); and

(xi) The provision of goods and services by engineers, ground and equipment maintenance staff, cargo handlers, catering staff, and customer

services personnel, and the provision of facilities such as passenger lounges, counter space, ground handling equipment, and hangars.

(2) *Activities not considered incidental to the international operation of ships or aircraft.* Examples of activities that are not considered incidental to the international operation of ships or aircraft include—

(i) The sale of or arranging for train travel, bus transfers, single day shore excursions, or land tour packages;

(ii) Arranging for hotel accommodations within the United States other than as provided in paragraph (g)(1)(vii) of this section;

(iii) The sale of airline tickets or cruise tickets other than as provided in paragraph (g)(1)(ii), (iii), or (vi) of this section;

(iv) The sale or rental of real property;

(v) Treasury activities involving the investment of excess funds or funds awaiting repatriation, even if derived from the international operation of ships or aircraft;

(vi) The carriage of passengers or cargo on ships or aircraft on domestic legs of transportation not treated as either international operation of ships or aircraft under paragraph (f) of this section or as an activity that is incidental to such operation under paragraph (g)(1) of this section;

(vii) The carriage of cargo by bus, truck or rail by a foreign corporation between a U.S. inland point and a U.S. gateway port or airport preceding or following the international carriage of such cargo by the foreign corporation; and

(viii) The provision of containers or other related equipment by the foreign corporation within the United States other than as provided in paragraph (g)(1)(x) of this section, including warehousing.

(3) *Other services.* [Reserved]

(4) *Activities involved in a pool, partnership, strategic alliance, joint operating agreement, code-sharing arrangement or other joint venture.* Notwithstanding paragraph (g)(1) of this section, an activity is considered incidental to the international operation of ships or aircraft by a foreign corporation, and income derived by the foreign corporation with respect to such activity is deemed to be income derived from the international operation of ships or aircraft, if the activity is performed by or pursuant to a pool, partnership, strategic alliance, joint operating agreement, code-sharing arrangement or other joint venture in which such foreign corporation participates directly, or indirectly through a fiscally transparent entity under the income tax laws of the United States, provided that—

(i) Such activity is incidental to the international operation of ships or aircraft by the pool, partnership, strategic alliance, joint operating agreement, code-sharing arrangement or other joint venture, and provided that it is described in paragraph (e)(2)(i) of this section; or

(ii) Such activity would be incidental to the international operation of ships or aircraft by the foreign corporation, or fiscally transparent entity if it performed such activity itself, and provided the foreign corporation is engaged or the fiscally transparent entity would be considered engaged if it were a foreign corporation in the operation of ships or aircraft under paragraph (e)(1) of this section.

(h) *Equivalent exemption*—(1) *General rule.* A foreign country grants an equivalent exemption when it exempts from taxation income from the international operation of ships or aircraft derived by corporations organized in the United States. Whether a foreign country provides an equivalent exemption must be determined separately with respect to each category of income, as provided in paragraph (h)(2) of this section. An equivalent exemption may be available for income derived from the international operation of ships even though income derived from the international operation of aircraft may not be exempt, and vice versa. For rules regarding foreign corporations organized in countries that provide exemptions only through an income tax convention, see paragraph (h)(3) of this section. An equivalent exemption may exist where the foreign country—

(i) Generally imposes no tax on income, including income from the international operation of ships or aircraft;

(ii) Provides an exemption from tax for income derived from the international operation of ships or aircraft, either by statute, decree, income tax convention, or otherwise; or

(iii) Exchanges diplomatic notes with the United States, or enters into an agreement with the United States, that provides for a reciprocal exemption for purposes of section 883.

(2) *Determining equivalent exemptions for each category of income.* Whether a foreign country grants an equivalent exemption must be determined separately with respect to income from the international operation of ships and income from the international operation of aircraft for each category of income listed in paragraphs (h)(2)(i) through (v), (vii), and (viii) of this section. If an exemption is unavailable in the foreign country for a particular category of income, the foreign country is not considered to grant an equivalent exemption with respect to that category of income. Income in that category is not considered to be the subject of an equivalent exemption and, thus, is not eligible for exemption from income tax in the United States, even though the foreign country may grant an equivalent exemption for other categories of income. With respect to paragraph (h)(2)(vi) of this section, a foreign country may be considered to grant an equivalent exemption for one or more types of income described in paragraph (g)(1) of this section. The following categories of income derived from the international operation of ships or aircraft may be exempt from United States income tax if an equivalent exemption is available—

(i) Income from the carriage of passengers and cargo;

(ii) Time or voyage (full) charter income of a ship or wet lease income of an aircraft;

(iii) Bareboat charter income of a ship or dry charter income of an aircraft;

(iv) Incidental bareboat charter income or incidental dry lease income;

(v) Incidental container-related income;

(vi) Income incidental to the international operation of ships or aircraft other than incidental income described in paragraphs (h)(2)(iv) and (v) of this section;

(vii) Capital gains derived by a qualified foreign corporation engaged in the international operation of ships or aircraft from the sale, exchange or other disposition of a ship, aircraft, container or related equipment or other moveable property used by that qualified foreign corporation in the international operation of ships or aircraft; and

(viii) Income from participation in a pool, partnership, strategic alliance, joint operating agreement, code-sharing arrangement, international operating agency, or other joint venture described in paragraph (e)(2) of this section.

(3) *Special rules with respect to income tax conventions*—(i) *Countries with only an income tax convention.* If a foreign country grants an exemption from tax for profits from the international operation of ships or aircraft only under an income tax convention with the United States, that exemption shall constitute an equivalent exemption with respect to a foreign corporation organized in that country only if—

(A) The foreign corporation satisfies the conditions for claiming benefits with respect to such profits under the income tax convention; and

(B) The profits that are exempt from tax pursuant to the shipping and air transport or gains article of the income tax convention and are described within a category of income included in paragraphs (h)(2)(i) through (viii) of this section.

(ii) *Countries with both an income tax convention and an equivalent exemption*—(A) *General rule.* If a foreign country grants an exemption from tax for profits from the international operation of ships or aircraft under the shipping and air transport or gains article of an income tax convention with the United States and also by some other means (for example, by diplomatic note or domestic law of the foreign country), a foreign corporation may elect annually whether to claim an exemption from tax under section 883 or the income tax convention. Except as provided in paragraph (h)(3)(ii)(B) of this section, the foreign

corporation must apply the elected exemption (section 883 or the income tax convention) to all categories of income described in paragraph (h)(2) of this section. If the foreign corporation elects to claim the exemption under section 883, it must satisfy all of the requirements for claiming the exemption under section 883. If the foreign corporation elects to claim the exemption under the income tax convention, it must satisfy all of the requirements and conditions for claiming benefits under the income tax convention. *See* §1.883–4(b)(3) for rules concerning relying on shareholders resident in a foreign country that grants an equivalent exemption under an income tax convention to satisfy the stock ownership test of paragraph (c)(2) of this section.

(B) *Special rule for claiming simultaneous benefits under section 883 and an income tax convention.* If a foreign corporation that is organized in a country that grants an exemption from tax under an income tax convention and also by some other means (such as by diplomatic note or domestic law of the foreign country) with respect to a specific category of income described in paragraph (h)(2) of this section, and the foreign corporation elects to claim the exemption under the income tax convention, the foreign corporation may nonetheless simultaneously claim an exemption under section 883 with respect to a category of income exempt from tax by such other means if the foreign corporation—

(*1*) Satisfies the requirements of paragraphs (h)(3)(i)(A) and (B) of this section for each category of income;

(*2*) Satisfies one of the stock ownership tests of paragraph (c)(2) of this section; and

(*3*) Complies with the substantiation and reporting requirements in paragraph (c)(3) of this section.

(iii) *Participation in certain joint ventures.* If a foreign country grants an exemption for a category of income only through an income tax convention, a foreign corporation that is organized in that country and that derives income, directly or indirectly, through a participation in a pool, partnership, strategic alliance, joint operating agreement, code-sharing arrangement, or other joint venture described in paragraph (e)(2) of this section, may treat that exemption as an equivalent exemption even if the foreign corporation would not be eligible to claim benefits under the income tax convention for that category of income solely because the joint venture was not fiscally transparent, within the meaning of §1.894–1(d)(3)(iii)(A), with respect to that category of income under the income tax laws of the foreign corporation's country of residence.

(iv) *Independent interpretation of income tax conventions.* Nothing in this section nor §§1.883–2 through 1.883–5 affects the rights or obligations under any income tax convention between the United States and a foreign country. The definitions provided in this section and §§1.883–2 through 1.883–5 shall not give meaning to similar or identical terms used in an income tax convention, or provide guidance regarding the scope of any exemption provided by such convention, unless the income tax convention entered into force after August 26, 2003, and it, or its legislative history, explicitly refers to section 883 and guidance promulgated under that section for its meaning.

(4) *Exemptions not qualifying as equivalent exemptions*—(i) *General rule.* Certain types of exemptions provided to corporations organized in the United States by foreign countries do not satisfy the equivalent exemption requirements of this section. Paragraphs (h)(4)(ii) through (vii) of this section provide descriptions of some of the types of exemptions that do not qualify as equivalent exemptions for purposes of this section.

(ii) *Reduced tax rate or time limited exemption.* The exemption granted by the foreign country's law or income tax convention must be a complete exemption. The exemption may not constitute merely a reduction to a nonzero rate of tax levied against the income of corporations organized in the United States derived from the international operation of ships or aircraft or a temporary reduction to a zero rate of tax, such as in the case of a tax holiday.

(iii) *Inbound or outbound freight tax.* With respect to the carriage of cargo, the foreign country must provide an exemption from tax for income from transporting freight both inbound and

outbound. For example, a foreign country that imposes tax only on outbound freight will not be treated as granting an equivalent exemption for income from transporting freight inbound into that country.

(iv) *Exemptions for limited types of cargo.* A foreign country must provide an exemption from tax for income from transporting all types of cargo. For example, if a foreign country were generally to impose tax on income from the international carriage of cargo but were to provide a statutory exemption for income from transporting agricultural products, the foreign country would not be considered to grant an equivalent exemption with respect to income from the international carriage of cargo, including agricultural products.

(v) *Territorial tax systems.* A foreign country with a territorial tax system will be treated as granting an equivalent exemption if it treats all income derived from the international operation of ships or aircraft derived by a U.S. corporation as entirely foreign source and therefore not subject to tax, including income derived from a voyage or flight that begins or ends in that foreign country.

(vi) *Countries that tax on a residence basis.* A foreign country that provides an equivalent exemption to corporations organized in the United States but also imposes a residence-based tax on certain corporations organized in the United States may nevertheless be considered to grant an equivalent exemption if the residence-based tax is imposed only on a corporation organized in the United States that maintains its center of management and control or other comparable attributes in that foreign country. If the residence-based tax is imposed on corporations organized in the United States and engaged in the international operation of ships or aircraft that are not managed and controlled in that foreign country, the foreign country shall not be treated as a qualified foreign country and shall not be considered to grant an equivalent exemption for purposes of this section.

(vii) *Exemptions within categories of income.* With respect to paragraphs (h)(2)(i) through (v), (vii), and (viii) of this section, a foreign country must provide an exemption from tax for all income in a category of income, as defined in paragraph (h)(2) of this section. For example, a country that exempts income from the bareboat charter of passenger aircraft but not the bareboat charter of cargo aircraft does not provide an equivalent exemption. However, an equivalent exemption may be available for income derived from the international operation of ships even though income derived from the international operation of aircraft may not be exempt, and vice versa. With respect to paragraph (h)(2)(vi) of this section, a foreign country may be considered to grant an equivalent exemption for one or more types of income described in paragraph (g)(1) of this section.

(i) *Treatment of possessions.* For purposes of this section, a possession of the United States will be treated as a foreign country. A possession of the United States will be considered to grant an equivalent exemption and will be treated as a qualified foreign country if it applies a mirror system of taxation. If a possession does not apply a mirror system of taxation, the possession may nevertheless be a qualified foreign country if, for example, it provides for an equivalent exemption through its internal law. A possession applies the mirror system of taxation if the U.S. Internal Revenue Code of 1986, as amended, applies in the possession with the name of the possession used instead of ''United States'' where appropriate.

(j) *Expenses related to qualified income.* If a qualified foreign corporation derives qualified income from the international operation of ships or aircraft as well as income that is not qualified income, and the nonqualified income is effectively connected with the conduct of a trade or business within the United States, the foreign corporation may not deduct from such nonqualified income any amount otherwise allowable as a deduction from qualified income, if that qualified income is excluded under this section. See section 265(a)(1).

[T.D. 9087, 68 FR 51400, Aug. 26, 2003; 69 FR 7995, Feb. 20, 2004, as amended by T.D. 9332, 72 FR 34605, June 25, 2007; 72 FR 45159, Aug. 13, 2007; T.D. 9502, 75 FR 56861, Sept. 17, 2010]

§ 1.883–2 Treatment of publicly-traded corporations.

(a) *General rule.* A foreign corporation satisfies the stock ownership test of § 1.883–1(c)(2) if it is considered a publicly-traded corporation and satisfies the substantiation and reporting requirements of paragraphs (e) and (f) of this section. To be considered a publicly-traded corporation, the stock of the foreign corporation must be primarily traded and regularly traded, as defined in paragraphs (c) and (d) of this section, respectively, on one or more established securities markets, as defined in paragraph (b) of this section, in either the United States or any qualified foreign country.

(b) *Established securities market*—(1) *General rule.* For purposes of this section, the term *established securities market* means, for any taxable year—

(i) A foreign securities exchange that is officially recognized, sanctioned, or supervised by a governmental authority of the qualified foreign country in which the market is located, and has an annual value of shares traded on the exchange exceeding $1 billion during each of the three calendar years immediately preceding the beginning of the taxable year;

(ii) A national securities exchange that is registered under section 6 of the Securities Act of 1934 (15 U.S.C. 78f);

(iii) A United States over-the-counter market, as defined in paragraph (b)(4) of this section;

(iv) Any exchange designated under a Limitation on Benefits article in a United States income tax convention; and

(v) Any other exchange that the Secretary may designate by regulation or otherwise.

(2) *Exchanges with multiple tiers.* If an exchange in a foreign country has more than one tier or market level on which stock may be separately listed or traded, each such tier shall be treated as a separate exchange.

(3) *Computation of dollar value of stock traded.* For purposes of paragraph (b)(1)(i) of this section, the value in U.S. dollars of shares traded during a calendar year shall be determined on the basis of the dollar value of such shares traded as reported by the International Federation of Stock Exchanges located in Paris, or, if not so reported, then by converting into U.S. dollars the aggregate value in local currency of the shares traded using an exchange rate equal to the average of the spot rates on the last day of each month of the calendar year.

(4) *Over-the-counter market.* An over-the-counter market is any market reflected by the existence of an inter-dealer quotation system. An inter-dealer quotation system is any system of general circulation to brokers and dealers that regularly disseminates quotations of stocks and securities by identified brokers or dealers, other than by quotation sheets that are prepared and distributed by a broker or dealer in the regular course of business and that contain only quotations of such broker or dealer.

(5) *Discretion to determine that an exchange does not qualify as an established securities market.* The Commissioner may determine that a securities exchange that otherwise meets the requirements of paragraph (b) of this section does not qualify as an established securities market, if—

(i) The exchange does not have adequate listing, financial disclosure, or trading requirements (or does not adequately enforce such requirements); or

(ii) There is not clear and convincing evidence that the exchange ensures the active trading of listed stocks.

(c) *Primarily traded.* For purposes of this section, stock of a corporation is primarily traded in a country on one or more established securities markets, as defined in paragraph (b) of this section, if, with respect to each class of stock described in paragraph (d)(1)(i) of this section (relating to classes of stock relied on to meet the regularly traded test)—

(1) The number of shares in each such class that are traded during the taxable year on all established securities markets in that country exceeds

(2) The number of shares in each such class that are traded during that year on established securities markets in any other single country.

(d) *Regularly traded*—(1) *General rule.* For purposes of this section, stock of a corporation is regularly traded on one or more established securities markets,

as defined in paragraph (b) of this section, if—

(i) One or more classes of stock of the corporation that, in the aggregate, represent more than 50 percent of the total combined voting power of all classes of stock of such corporation entitled to vote and of the total value of the stock of such corporation are listed on such market or markets during the taxable year; and

(ii) With respect to each class relied on to meet the more than 50 percent requirement of paragraph (d)(1)(i) of this section—

(A) Trades in each such class are effected, other than in *de minimis* quantities, on such market or markets on at least 60 days during the taxable year (or ⅙ of the number of days in a short taxable year); and

(B) The aggregate number of shares in each such class that are traded on such market or markets during the taxable year are at least 10 percent of the average number of shares outstanding in that class during the taxable year (or, in the case of a short taxable year, a percentage that equals at least 10 percent of the average number of shares outstanding in that class during the taxable year multiplied by the number of days in the short taxable year, divided by 365).

(2) *Classes of stock traded on a domestic established securities market treated as meeting trading requirements.* A class of stock that is traded during the taxable year on an established securities market located in the United States shall be considered to meet the trading requirements of paragraph (d)(1)(ii) of this section if the stock is regularly quoted by dealers making a market in the stock. A dealer makes a market in a stock only if the dealer regularly and actively offers to, and in fact does, purchase the stock from, and sell the stock to, customers who are not related persons (as defined in section 954(d)(3)) with respect to the dealer in the ordinary course of a trade or business.

(3) *Closely-held classes of stock not treated as meeting trading requirements*—(i) *General rule.* Except as provided in paragraph (d)(3)(ii) of this section, a class of stock of a foreign corporation that otherwise meets the requirements of paragraph (d)(1) or (2) of this section shall not be treated as meeting such requirements for a taxable year if, for more than half the number of days during the taxable year, one or more persons who own at least 5 percent of the vote and value of the outstanding shares of the class of stock, as determined under paragraph (d)(3)(iii) of this section (each a 5-percent shareholder), own, in the aggregate, 50 percent or more of the vote and value of the outstanding shares of the class of stock. If one or more 5-percent shareholders own, in the aggregate, 50 percent or more of the vote and value of the outstanding shares of the class of stock, such shares held by the 5-percent shareholders will constitute a closely-held block of stock.

(ii) *Exception.* Paragraph (d)(3)(i) of this section shall not apply to a class of stock if the foreign corporation can establish that qualified shareholders, as defined in §1.883–4(b), applying the attribution rules of §1.883–4(c), own sufficient shares in the closely-held block of stock to preclude nonqualified shareholders in the closely-held block of stock from owning 50 percent or more of the total value of the class of stock of which the closely-held block is a part for more than half the number of days during the taxable year. Any shares that are owned, after application of the attribution rules in §1.883–4(c), by a qualified shareholder shall not also be treated as owned by a nonqualified shareholder in the chain of ownership for purposes of the preceding sentence. A foreign corporation must obtain the documentation described in §1.883–4(d) from the qualified shareholders relied upon to satisfy this exception. However, no person otherwise treated as a qualified shareholder under §1.883–4(b) may be treated for purposes of this paragraph (d)(3) as a qualified shareholder if such person's interest in the foreign corporation, or in any intermediary corporation, is held through bearer shares that are not maintained during the relevant period in a dematerialized or immobilized book-entry system, as described in §1.883–1(c)(3)(i)(G).

(iii) *Five-percent shareholders*—(A) *Related persons*. Solely for purposes of determining whether a person is a 5-percent shareholder, persons related within the meaning of section 267(b) shall be treated as one person. In determining whether two or more corporations are members of the same controlled group under section 267(b)(3), a person is considered to own stock owned directly by such person, stock owned through the application of section 1563(e)(1), and stock owned through the application of section 267(c). In determining whether a corporation is related to a partnership under section 267(b)(10), a person is considered to own the partnership interest owned directly by such person and the partnership interest owned through the application of section 267(e)(3).

(B) *Investment companies*. For purposes of this paragraph (d)(3), an investment company registered under the Investment Company Act of 1940, as amended (54 Stat. 789), shall not be treated as a 5-percent shareholder.

(4) *Anti-abuse rule*. Trades between or among related persons described in section 267(b), as modified by paragraph (d)(3)(iii) of this section, and trades conducted in order to meet the requirements of paragraph (d)(1) of this section shall be disregarded. A class of stock shall not be treated as meeting the trading requirements of paragraph (d)(1) of this section if there is a pattern of trades conducted to meet the requirements of that paragraph. For example, trades between two persons that occur several times during the taxable year may be treated as an arrangement or a pattern of trades conducted to meet the trading requirements of paragraph (d)(1)(ii) of this section.

(5) *Example*. The closely-held test in paragraph (d)(3) of this section is illustrated by the following example:

Example. Closely-held exception. (i) *Facts.* X is a foreign corporation organized in a qualified foreign country and engaged in the international operation of ships. X has one class of stock, which is primarily traded on an established securities market in the qualified foreign country. The stock of X meets the regularly traded requirements of paragraph (d)(1)(ii) of this section without regard to paragraph (d)(3)(i) of this section. A, B, C and D are four members of the corporation's founding family who each own, during the entire taxable year, 25 percent of the stock of Hold Co, a company that issues registered shares. Hold Co, in turn, owns 60 percent of the stock of X during the entire taxable year. The remaining 40 percent of the stock of X is not owned by any 5-percent shareholder, as determined under paragraph (d)(3)(iii) of this section. A, B, and C are not residents of a qualified foreign country, but D is a resident of a qualified foreign country.

(ii) *Analysis.* Because Hold Co owns 60 percent of the stock of X for more than half the number of days during the taxable year, Hold Co is a 5-percent shareholder that owns 50 percent or more of the value of the stock of X. Thus, the shares owned by Hold Co constitute a closely-held block of stock. Under paragraph (d)(3)(i) of this section, the stock of X will not be regularly traded within the meaning of paragraph (d)(1) of this section unless X can establish, under paragraph (d)(3)(ii) of this section, that qualified shareholders within the closely-held block of stock own sufficient shares in the closely-held block of stock to preclude nonqualified shareholders in the closely-held block of stock from owning 50 percent or more of the value of the outstanding shares in the class of stock for more than half the number of days during the taxable year. A, B, and C are not qualified shareholders within the meaning of §1.883–4(b) because they are not residents of a qualified foreign country, but D is a resident of a qualified foreign country and therefore is a qualified shareholder. D owns 15 percent of the outstanding shares of X through Hold Co (25 percent × 60 percent = 15 percent) while A, B, and C in the aggregate own 45 percent of the outstanding shares of X through Hold Co. D, therefore, owns sufficient shares in the closely-held block of stock to preclude the nonqualified shareholders in the closely-held block of stock, A, B and C, from owning 50 percent or more of the value of the class of stock (60 percent − 15 percent = 45 percent) of which the closely-held block is a part. Provided that X obtains from D the documentation described in §1.883–4(d), X's sole class of stock meets the exception in paragraph (d)(3)(ii) of this section and will not be disqualified from the regularly traded test by virtue of paragraph (d)(3)(i) of this section.

(e) *Substantiation that a foreign corporation is publicly traded*—(1) *General rule*. A foreign corporation that relies on the publicly traded test of this section to meet the stock ownership test of §1.883–1(c)(2) must substantiate that the stock of the foreign corporation is primarily and regularly traded on one or more established securities markets, as that term is defined in paragraph (b)

of this section. If one of the classes of stock on which the foreign corporation relies to meet this test is closely-held within the meaning of paragraph (d)(3)(i) of this section, the foreign corporation must obtain an ownership statement described in §1.883–4(d) from each qualified shareholder and intermediary that it relies upon to satisfy the exception to the closely-held test, but only to the extent such statement would be required if the foreign corporation were relying on the qualified shareholder stock ownership test of §1.883–4 with respect to those shares of stock. The foreign corporation must also maintain and provide to the Commissioner upon request a list of its shareholders of record and any other relevant information known to the foreign corporation supporting its entitlement to an exemption under this section.

(2) *Availability and retention of documents for inspection.* A foreign corporation seeking qualified foreign corporation status must retain the documentation described in paragraph (e)(1) of this section until the expiration of the statute of limitations for its taxable year to which the documentation relates. The foreign corporation must make such documentation available for inspection at such time and such place as the Commissioner requests in writing under §1.883–1(c)(3)(ii)(A) or (B).

(f) *Reporting requirements.* A foreign corporation relying on this section to satisfy the stock ownership test of §1.883–1(c)(2) must provide the following information in addition to the information required in §1.883–1(c)(3) to be included in its Form 1120–F, ''U.S. Income Tax Return of a Foreign Corporation,'' for the taxable year. The information must be current as of the end of the corporation's taxable year and must include the following—

(1) The name of the country in which the stock is primarily traded;

(2) The name of the established securities market or markets on which the stock is listed;

(3) A description of each class of stock relied upon to meet the requirements of paragraph (d) of this section, including whether the class is issued in registered or bearer form and whether any such bearer shares are maintained in a dematerialized or immobilized book-entry system, as described in §1.883–1(c)(3)(i)(G), the number of shares issued and outstanding in that class as of the close of the taxable year, and the relative value of each class in relation to the total value of all shares of stock of the corporation that are outstanding as of the close of the taxable year;

(4) For each class of stock relied upon to meet the requirements of paragraph (d) of this section, if one or more 5-percent shareholders, as defined in paragraph (d)(3)(i) of this section, own in the aggregate 50 percent or more of the vote and value of the outstanding shares of that class of stock for more than half the number of days during the taxable year—

(i) The days during the taxable year of the corporation in which the stock was closely-held without regard to the exception in paragraph (d)(3)(ii) of this section and the percentage of the vote and value of the class of stock that is owned by 5-percent shareholders during such days;

(ii) With respect to all qualified shareholders that own directly, or by application of the attribution rules in §1.883–4(c), shares of the closely-held block of stock and that the foreign corporation relies on to satisfy the exception provided by paragraph (d)(3)(ii) of this section—

(A) The number of such qualified shareholders;

(B) The total percentage of the value of the shares owned, directly or indirectly, by such qualified shareholders by country of residence, determined under §1.883–4(b)(2) (residence of individual shareholders) or §1.883–4(d)(3) (special rules for residence of certain shareholders); and

(C) The number of days during the taxable year of the foreign corporation that such qualified shareholders owned, directly or indirectly, their shares in the closely held block of stock.

(5) Any other relevant information specified by Form 1120–F and its accompanying instructions.

[T.D. 9087, 68 FR 51406, Aug. 26, 2003, as amended by T.D. 9332, 72 FR 34606, June 25, 2007; T.D. 9502, 75 FR 56862, Sept. 17, 2010; 75 FR 63380, Oct. 15, 2010]

§ 1.883–3 Treatment of controlled foreign corporations.

(a) *General rule.* A foreign corporation satisfies the stock ownership test of § 1.883–1(c)(2) if it satisfies the qualified U.S. person ownership test in paragraph (b) of this section and the substantiation and reporting requirements of paragraphs (c) and (d) of this section, respectively. A foreign corporation that fails the qualified U.S. person ownership test of paragraph (b) of this section can satisfy the stock ownership test of § 1.883–1(c)(2) if it meets either the publicly-traded test of § 1.883–2(a) or the qualified shareholder stock ownership test of § 1.883–4(a).

(b) *Qualified U.S. person ownership test*—(1) *General rule.* A foreign corporation satisfies the qualified U.S. person ownership test only if the following two conditions are satisfied concurrently during more than half the days in its taxable year:

(i) The foreign corporation is a controlled foreign corporation (within the meaning of section 957(a)).

(ii) One or more qualified U.S. persons own more than 50 percent of the total value of all the outstanding stock of the foreign corporation (within the meaning of section 958(a) and paragraph (b)(4) of this section).

(2) *Qualified U.S. person.* For purposes of this section, a *qualified U.S. person* is a United States citizen or resident alien, a domestic corporation, or a domestic trust described in section 501(a), but only if the person provides the controlled foreign corporation an ownership statement described in paragraph (c)(2) of this section, and the controlled foreign corporation meets the reporting requirements of paragraph (d) of this section with respect to that person.

(3) *Treatment of bearer shares.* For purposes of paragraph (b)(1)(ii) of this section, any shares of the foreign corporation or of any intermediary corporation that are issued in bearer form, shall be treated as not owned by qualified U.S. persons if the bearer shares are not maintained in a dematerialized or immobilized book-entry system, as described in § 1.883–1(c)(3)(i)(G).

(4) *Ownership attribution through certain domestic entities.* For purposes of paragraph (b)(1)(ii) of this section, stock owned, directly or indirectly, by or for a domestic partnership, a domestic trust not described in section 501(a), or a domestic estate, shall be treated as owned proportionately by the partners, beneficiaries, grantors, or other interest holders, respectively, under the rules of section 958(a), which shall be applied by treating each domestic entity as a foreign entity. Stock that is considered owned by a person under this paragraph (b)(4) shall, for purposes of applying this paragraph (b)(4) to such person, be treated as actually owned by such person.

(5) *Examples.* The following examples illustrate the qualified U.S. person ownership test of paragraph (b)(1) of this section:

Example 1. Ship Co is a controlled foreign corporation (within the meaning of section 957(a)) for more than half the days of its taxable year and is organized in a qualified foreign country. A domestic partnership owns all of the outstanding stock of Ship Co for the entire taxable year. All of the partners in the domestic partnership are residents of foreign countries and not citizens of the United States. Ship Co does not satisfy the qualified U.S. person ownership test of paragraph (b)(1) of this section because qualified U.S. persons do not own shares of Ship Co stock with a value that is greater than 50 percent of the total value of the outstanding stock of the corporation for at least half the days of Ship Co's taxable year. Therefore, to satisfy the stock ownership test of § 1.883–1(c)(2) and constitute a qualified foreign corporation, Ship Co must meet the qualified shareholder stock ownership test of § 1.883–4(a).

Example 2. Ship Co is a controlled foreign corporation (within the meaning of section 957(a)) for more than half the days of its taxable year and is organized in a qualified foreign country. Ship Co has a single class of stock outstanding. For Ship Co's entire taxable year, a foreign corporation (Corp A), that is wholly owned by a resident of a foreign country who is not a U.S. citizen, owns 40 percent of the outstanding Ship Co stock. During that same period, a domestic partnership owns the remaining 60 percent of the outstanding Ship Co stock. The domestic partnership is wholly owned by 20 United States citizens, each of whom owns a 5-percent partnership interest for Ship Co's entire taxable year. Ship Co meets the qualified U.S. person ownership test of paragraph (b)(1) of this section because during more than half the days in its taxable year it was a controlled foreign corporation within the meaning of section 957(a), and, applying the ownership attribution rules of paragraph

(b)(4) of this section, qualified U.S. persons (the partners in the domestic partnership) owned Ship Co stock with a value that is greater than 50 percent of the total value of all the outstanding Ship Co shares. Therefore, Ship Co will meet the stock ownership test of §1.883–1(c)(2) if it satisfies the substantiation and reporting requirements of paragraphs (c) and (d) of this section with respect to the partners in the domestic partnership. Alternatively, if four or more partners in the domestic partnership were not qualified U.S. persons, Ship Co would not meet the qualified U.S. person ownership test of paragraph (b)(1) of this section because, even though during more than half the days in its taxable year it would have been a controlled foreign corporation within the meaning of section 957(a), qualified U.S. persons would not have owned Ship Co stock with a value that is greater than 50 percent of the total value of all the outstanding Ship Co shares during that period.

Example 3. Ship Co is a controlled foreign corporation (within the meaning of section 957(a)) and is organized in a qualified foreign country. Ship Co has two classes of stock outstanding, Class A representing 60 percent of the vote and value and Class B representing the remaining 40 percent of the vote and value of all the shares outstanding of Ship Co. The Class A stock is issued in bearer form and is maintained in a dematerialized book-entry system, as described in §1.883–1(c)(3)(i)(G). The Class B stock is also issued in bearer form, but is not maintained in a dematerialized or immobilized book-entry system. For Ship Co's entire taxable year, a United States citizen A holds all the Class A stock and nonresident alien individual B owns all the Class B stock. Although the Class A stock is issued in bearer form, Ship Co will satisfy the qualified U.S. person ownership test of paragraph (b)(1) of this section because the Class A stock is maintained in a dematerialized book-entry system on behalf of A. The Class B stock is not owned by a qualified U.S. person but is taken into account in determining the total value of Ship Co's outstanding stock. Alternatively, if the Class B stock were owned by a qualified U.S. person, the results would be similar. Class B stock would not be taken into account in determining if the qualified U.S. person ownership test were satisfied, but would be taken into account in determining the total value of Ship Co's outstanding stock.

(c) *Substantiation of CFC stock ownership*—(1) *In general.* A controlled foreign corporation must establish all of the facts necessary to demonstrate to the Commissioner that it satisfies the qualified U.S. person ownership test of paragraph (b)(1) of this section by obtaining a written ownership statement (described in paragraph (c)(2) or (3) of this section, as applicable), signed under penalties of perjury by an individual authorized to sign that person's Federal tax or information return, from—

(i) Each qualified U.S. person whose ownership of stock of the controlled foreign corporation is taken into account for purposes of meeting the qualified U.S. person ownership test; and

(ii) Each domestic intermediary described in paragraph (b)(4) of this section, each foreign intermediary (including a foreign corporation, partnership, trust, or estate), and mere legal owners or record holders acting as nominees in the chain of ownership between each such qualified U.S. person and the controlled foreign corporation, if any.

(2) *Ownership statements from qualified U.S. persons.* An ownership statement from a qualified U.S. person must include—

(i) The qualified U.S. person's name, permanent address, and taxpayer identification number;

(ii) If the qualified U.S. person directly owns shares in the controlled foreign corporation, the number of shares of each class of stock of the controlled foreign corporation owned by the qualified U.S. person, whether any shares are issued in bearer form, whether any bearer shares are maintained in a dematerialized or immobilized book-entry system, as described in §1.883–1(c)(3)(i)(G), and the period (or periods) in the taxable year of the controlled foreign corporation during which the qualified U.S. person owned the shares;

(iii) If the qualified U.S. person indirectly owns shares in the controlled foreign corporation through a foreign or domestic intermediary described in paragraph (c)(1)(ii) of this section, the name of each intermediary, the amount and nature of the qualified U.S. person's interest in each intermediary, the period (or periods) in the taxable year of the controlled foreign corporation during which the qualified U.S. person held such interest, and, with respect to any intermediary foreign corporation, whether any shares

are issued in bearer form and whether any such bearer shares are maintained in a dematerialized or immobilized book-entry system, as described in §1.883–1(c)(3)(i)(G); and

(iv) Any other information specified in published guidance by the Internal Revenue Service (see §601.601(d)(2) of this chapter).

(3) *Ownership statements from intermediaries.* An ownership statement from a domestic or foreign intermediary must include:

(i) The intermediary's name, permanent address, and taxpayer identification number, if any.

(ii) If the intermediary directly owns stock in the controlled foreign corporation, the number of shares of each class of stock of the controlled foreign corporation owned by the intermediary, whether such shares are issued in bearer form and maintained in a dematerialized or immobilized book-entry system, as described in §1.883–1(c)(3)(i)(G), and the period (or periods) in the taxable year of the controlled foreign corporation during which the intermediary owned the shares.

(iii) If the intermediary indirectly owns the stock of the controlled foreign corporation, the name and address of each intermediary in the chain of ownership between it and the controlled foreign corporation, the period (or periods) in the taxable year of the controlled foreign corporation during which the intermediary owned the shares, the percentage of its indirect ownership interest in the controlled foreign corporation, and, if any intermediary in the chain of ownership is a foreign corporation, whether any shares of such intermediary are issued in bearer form and if any such bearer shares are maintained in a dematerialized or immobilized book- entry system, as described in §1.883–1(c)(3)(i)(G).

(iv) Any other information specified in published guidance by the Internal Revenue Service (see §601.601(d)(2) of this chapter).

(4) *Three-year period of validity.* The rules of §1.883–4(d)(2)(ii) shall apply for determining the validity of the ownership statements required under paragraph (c)(2) of this section.

(5) *Availability and retention of documents for inspection.* The foreign corporation seeking qualified foreign corporation status must retain the ownership statements described in this paragraph (c) until the expiration of the statute of limitations for its taxable year to which the ownership statements relate. The ownership statements must be made available for inspection at such time and place as the Commissioner may request in writing in accordance with §1.883–1(c)(3)(ii).

(d) *Reporting requirements.* A controlled foreign corporation that relies on this section to satisfy the stock ownership test of §1.883–1(c)(2) must include the following information (in addition to the information required by §1.883–1(c)(3)) with its Form 1120–F, ''U.S. Income Tax Return of a Foreign Corporation'', filed for its taxable year. This information must be consistent with the ownership statements obtained by the controlled foreign corporation pursuant to paragraph (c) of this section and must be current as of the end of the corporation's taxable year—

(1) The relative value of the shares of the controlled foreign corporation that are owned (directly, and indirectly applying the rules of paragraph (b)(4) of this section) by all qualified U.S. persons identified in paragraph (c)(2) of this section as compared to the value of all outstanding shares of the corporation;

(2) The period (or periods) in the taxable year during which such qualified U.S. persons held such shares;

(3) The period (or periods) in the taxable year during which the foreign corporation was a controlled foreign corporation;

(4) A statement as to whether the controlled foreign corporation or any intermediary corporation had bearer shares outstanding during the taxable year, and whether any such bearer shares taken into account for purposes of satisfying the qualified U.S. person ownership test are maintained in a dematerialized or immobilized book-entry system, as described in §1.883–1(c)(3)(i)(G); and

(5) Any other information specified by Form 1120–F, and its accompanying instructions, or in published guidance

by the Internal Revenue Service (*see* § 601.601(d)(2) of this chapter).

[T.D. 9502, 75 FR 56863, Sept. 17, 2010]

§ 1.883–4 Qualified shareholder stock ownership test.

(a) *General rule.* A foreign corporation satisfies the stock ownership test of § 1.883–1(c)(2) if more than 50 percent of the value of its outstanding shares is owned, or treated as owned by applying the attribution rules of paragraph (c) of this section, for at least half of the number of days in the foreign corporation's taxable year by one or more qualified shareholders, as defined in paragraph (b) of this section. A shareholder may be a qualified shareholder with respect to one category of income while not being a qualified shareholder with respect to another. A foreign corporation will not be considered to satisfy the stock ownership test of § 1.883–1(c)(2) pursuant to this section unless the foreign corporation meets the substantiation and reporting requirements of paragraphs (d) and (e) of this section.

(b) *Qualified shareholder*—(1) *General rule.* A shareholder is a qualified shareholder only if the shareholder—

(i) With respect to the category of income for which the foreign corporation is seeking an exemption, is—

(A) An individual who is a resident, as described in paragraph (b)(2) of this section, of a qualified foreign country;

(B) The government of a qualified foreign country (or a political subdivision or local authority of such country);

(C) A foreign corporation that is organized in a qualified foreign country and meets the publicly traded test of § 1.883–2(a);

(D) A not-for-profit organization described in paragraph (b)(4) of this section that is not a pension fund as defined in paragraph (b)(5) of this section and that is organized in a qualified foreign country;

(E) An individual beneficiary of a pension fund (as defined in paragraph (b)(5)(iv) of this section) that is administered in or by a qualified foreign country, who is treated as a resident under paragraph (d)(3)(iii) of this section, of a qualified foreign country; or

(F) A shareholder of a foreign corporation that is an airline covered by a bilateral Air Services Agreement in force between the United States and the qualified foreign country in which the airline is organized, provided the United States has not waived the ownership requirement in the Air Services Agreement, or that the ownership requirement has not otherwise been made ineffective;

(ii) Does not own its interest in the foreign corporation through bearer shares, either directly or by applying the attribution rules of paragraph (c) of this section, unless such bearer shares are maintained in a dematerialized or immobilized book-entry system, as described in § 1.883–1(c)(3)(i)(G); and

(iii) Provides to the foreign corporation the documentation required in paragraph (d) of this section and the foreign corporation meets the reporting requirements of paragraph (e) of this section with respect to such shareholder.

(2) *Residence of individual shareholders*—(i) *General rule.* An individual described in paragraph (b)(1)(i)(A) of this section is a resident of a qualified foreign country only if the individual is fully liable to tax as a resident in such country (e.g., an individual who is liable to tax on a remittance basis in a foreign country will not be treated as a resident of that country unless all residents of that country are taxed on a remittance basis only) and, in addition—

(A) The individual has a tax home, within the meaning of paragraph (b)(2)(ii) of this section, in that qualified foreign country for 183 days or more of the taxable year; or

(B) The individual is treated as a resident of a qualified foreign country based on special rules pursuant to paragraph (d)(3) of this section.

(ii) *Tax home.* For purposes of this section, an individual's tax home is considered to be located at the individual's regular or principal (if more than one regular) place of business. If the individual has no regular or principal place of business because of the nature of his business (or lack of a business), then the individual's tax home is located at his regular place of abode in a real and substantial sense. If an individual has no regular or principal place

of business and no regular place of abode in a real and substantial sense in a qualified foreign country for 183 days or more of the taxable year, that individual does not have a tax home for purposes of this section. A foreign estate or trust, as defined in section 7701(a)(31), does not have a tax home for purposes of this section. See paragraph (c)(3) of this section for alternative rules in the case of trusts or estates.

(3) *Certain income tax convention restrictions applied to shareholders.* For purposes of paragraph (b)(1) of this section, a shareholder described in paragraph (b)(1) of this section may be considered a resident of, or organized in, a qualified foreign country if that foreign country provides an exemption by means of an income tax convention with the United States, but only if the shareholder demonstrates that it is treated as a resident of that country under the convention and qualifies for benefits under any Limitation on Benefits article, and that the convention provides an exemption for the relevant category of income. If the convention has a requirement in the shipping and air transport article other than residence, such as place of registration or documentation of the ship or aircraft, the shareholder is not required to demonstrate that the corporation seeking qualified foreign corporation status could satisfy any such additional requirement.

(4) *Not-for-profit organizations.* The term *not-for-profit organization* means an organization that meets the following requirements—

(i) It is a corporation, association taxable as a corporation, trust, fund, foundation, league or other entity operated exclusively for religious, charitable, educational, or recreational purposes, and not organized for profit;

(ii) It is generally exempt from tax in its country of organization by virtue of its not-for-profit status; and

(iii) Either—

(A) More than 50 percent of its annual support is expended on behalf of individuals described in paragraph (b)(1)(i)(A) of this section (see paragraph (d)(3)(v) of this section for special rules to substantiate the residence of individual beneficiaries of not-for-profit organizations) and on behalf of U.S. exempt organizations that have received determination letters under section 501(c)(3); or

(B) More than 50 percent of its annual support is derived from individuals described in paragraph (b)(1)(i)(A) of this section (see paragraph (d)(3)(v) of this section for special rules to substantiate the residence of individual supporters of not-for-profit organizations).

(5) *Pension funds*—(i) *Pension fund defined.* The term *pension fund* shall mean a government pension fund or a nongovernment pension fund, as those terms are defined, respectively, in paragraphs (b)(5)(ii) and (iii) of this section, that is a trust, fund, foundation, or other entity that is established exclusively for the benefit of employees or former employees of one or more employers, the principal purpose of which is to provide retirement, disability, and death benefits to beneficiaries of such entity and persons designated by such beneficiaries in consideration for prior services rendered.

(ii) *Government pension funds.* A government pension fund is a pension fund that is a controlled entity of a foreign sovereign within the principles of §1.892–2T(c)(1) (relating to pension funds established for the benefit of employees or former employees of a foreign government).

(iii) *Nongovernment pension funds.* A nongovernment pension fund is a pension fund that—

(A) Is administered in a foreign country and is subject to supervision or regulation by a governmental authority (or other authority delegated to perform such supervision or regulation by a governmental authority) in such country;

(B) Is generally exempt from income taxation in its country of administration;

(C) Has 100 or more beneficiaries; and

(D) The trustees, directors or other administrators of which pension fund provide the documentation required in paragraph (d) of this section.

(iv) *Beneficiary of a pension fund.* The term *beneficiary of a pension fund* shall mean any person who has made contributions to a pension fund, as that term is defined in paragraph (b)(5)(i) of

this section, or on whose behalf contributions have been made, and who is currently receiving retirement, disability, or death benefits from the pension fund or can reasonably be expected to receive such benefits in the future, whether or not the person's right to receive benefits from the fund has vested. See paragraph (c)(7) of this section for rules regarding the computation of stock ownership through nongovernment pension funds.

(c) *Rules for determining constructive ownership* (1) *General rules for attribution*. For purposes of applying paragraph (a) of this section and the exception to the closely-held test in §1.883–1(d)(3)(ii), stock owned by or for a corporation, partnership, trust, estate, or mutual insurance company or similar entity shall be treated as owned proportionately by its shareholders, partners, beneficiaries, grantors, or other interest holders, as provided in paragraphs (c)(2) through (7) of this section. The proportionate interest rules of this paragraph (c) shall apply successively upward through the chain of ownership, and a person's proportionate interest shall be computed for the relevant days or period taken into account in determining whether a foreign corporation satisfies the requirements of paragraph (a) of this section. Stock treated as owned by a person by reason of this paragraph (c) shall be treated as actually owned by such person for purposes of this section. An owner of an interest in an association taxable as a corporation shall be treated as a shareholder of such association for purposes of this paragraph (c). Stock issued in bearer form will not be treated as owned proportionately by its shareholders unless the shares are maintained in a dematerialized or immobilized book-entry system, as described in §1.883–1(c)(3)(i)(G).

(2) *Partnerships*—(i) *General rule*. A partner shall be treated as having an interest in stock of a foreign corporation owned by a partnership in proportion to the least of—

(A) The partner's percentage distributive share of the partnership's dividend income from the stock;

(B) The partner's percentage distributive share of gain from disposition of the stock by the partnership; or

(C) The partner's percentage distributive share of the stock (or proceeds from the disposition of the stock) upon liquidation of the partnership.

(ii) *Partners resident in the same country*. For purposes of this paragraph, all qualified shareholders that are partners in a partnership and that are residents of, or organized in, the same qualified foreign country shall be treated as one partner. Thus, the percentage distributive shares of dividend income, gain and liquidation rights of all qualified shareholders that are partners in a partnership and that are residents of, or organized in, the same qualified foreign country are aggregated prior to determining the least of the three percentages set out in paragraph (c)(2)(i) of this section. For the meaning of the term *resident*, see paragraph (b)(2) of this section.

(iii) *Examples*. The rules of paragraph (c)(2)(ii) of this section are illustrated by the following examples:

Example 1. Stock held solely by qualified shareholders through a partnership. Country X grants an equivalent exemption. A and B are individual residents of Country X and are qualified shareholders within the meaning of paragraph (b)(1) of this section. A and B are the sole partners of Partnership P. P's only asset is the stock of Corporation Z, a Country X corporation seeking a reciprocal exemption under this section. A's distributive share of P's income and gain on the disposition of P's assets is 80 percent, but A's distributive share of P's assets (or the proceeds therefrom) on P's liquidation is 20 percent. B's distributive share of P's income and gain is 20 percent and B is entitled to 80 percent of the assets (or proceeds therefrom) on P's liquidation. Under the attribution rules of paragraph (c)(2)(ii) of this section, A and B will be treated as a single partner owning in the aggregate 100 percent of the stock of Z owned by P.

Example 2. Stock held by both qualified and nonqualified shareholders through a partnership. Assume the same facts as in *Example 1* except that C, an individual who is not a resident of a qualified foreign country, is also a partner in P and that C's distributive share of P's income is 60 percent. The distributive shares of A and B are the same as in *Example 1*, except that A's distributive share of income is 20 percent. Under the attribution rules of paragraph (c)(2)(ii) of this section, qualified shareholders A and B will be treated as a single partner owning in the aggregate 40 percent of the stock of Z owned by P (i.e., the lowest aggregate percentage of

A and B's distributive shares of dividend income (40 percent), gain (100 percent), and liquidation rights (100 percent) with respect to the Z stock). Thus, only 40 percent of the Z stock is treated as owned by qualified shareholders.

Example 3. Stock held through tiered partnerships. Country X grants an equivalent exemption. A and B are individual residents of Country X and are qualified shareholders within the meaning of paragraph (b)(1) of this section. A and B are the sole partners of Partnership P. P is a partner in Partnership P1, which owns the stock of Corporation Z, a Country X corporation seeking a reciprocal exemption under this section. Assume that P's distributive share of the dividend income, gain and liquidation rights with respect to the Z stock held by P1 is 40 percent. Assume that of the remaining partners of P1 only D is a qualified shareholder. D's distributive share of P1's dividend income and gain is 15 percent; D's distributive share of P1's assets on liquidation is 25 percent. Under the attribution rules of paragraph (c)(2)(ii) of this section, A and B, treated as a single partner, will own 40 percent of the Z stock owned by P1 (100 percent × 40 percent) and D will be treated as owning 15 percent of the Z stock owned by P1 (the least of D's dividend income (15 percent), gain (15 percent), and liquidation rights (25 percent) with respect to the Z stock). Thus, 55 percent of the Z stock owned by P1 is treated as owned by qualified shareholders.

(3) *Trusts and estates*—(i) *Beneficiaries.* In general, an individual shall be treated as having an interest in stock of a foreign corporation owned by a trust or estate in proportion to the individual's actuarial interest in the trust or estate, as provided in section 318(a)(2)(B)(i), except that an income beneficiary's actuarial interest in the trust will be determined as if the trust's only asset were the stock. The interest of a remainder beneficiary in stock will be equal to 100 percent minus the sum of the percentages of any interest in the stock held by income beneficiaries. The ownership of an interest in stock owned by a trust shall not be attributed to any beneficiary whose interest cannot be determined under the preceding sentence, and any such interest, to the extent not attributed by reason of this paragraph (c)(3)(i), shall not be considered owned by a beneficiary unless all potential beneficiaries with respect to the stock are qualified shareholders. In addition, a beneficiary's actuarial interest will be treated as zero to the extent that someone other than the beneficiary is treated as owning the stock under paragraph (c)(3)(ii) of this section. A substantially separate and independent share of a trust, within the meaning of section 663(c), shall be treated as a separate trust for purposes of this paragraph (c)(3)(i), provided that payment of income, accumulated income or corpus of a share of one beneficiary (or group of beneficiaries) cannot affect the proportionate share of income, accumulated income or corpus of another beneficiary (or group of beneficiaries).

(ii) *Grantor trusts.* A person is treated as the owner of stock of a foreign corporation owned by a trust to the extent that the stock is included in the portion of the trust that is treated as owned by the person under sections 671 through 679 (relating to grantors and others treated as substantial owners).

(4) *Corporations that issue stock.* A shareholder of a corporation that issues stock shall be treated as owning stock of a foreign corporation that is owned by such corporation on any day in a proportion that equals the value of the stock owned by such shareholder to the value of all stock of such corporation. If, however, there is an agreement, express or implied, that a shareholder of a corporation will not receive distributions from the earnings of stock owned by the corporation, the shareholder will not be treated as owning that stock owned by the corporation.

(5) *Taxable nonstock corporations.* A taxable nonstock corporation that is entitled in its country of organization to deduct from its taxable income amounts distributed for charitable purposes may deem a recipient of such charitable distributions to be a shareholder of such taxable nonstock corporation in the same proportion as the amount that such beneficiary receives in the taxable year bears to the total income of such taxable nonstock corporation in the taxable year. Whether each such recipient is a qualified shareholder may then be determined under paragraph (b) of this section or under the special rules of paragraph (d)(3)(vii) of this section.

(6) *Mutual insurance companies and similar entities.* Stock held by a mutual

insurance company, mutual savings bank, or similar entity (including an association taxable as a corporation that does not issue stock interests) shall be considered owned proportionately by the policyholders, depositors, or other owners in the same proportion that such persons share in the surplus of such entity upon liquidation or dissolution.

(7) *Computation of beneficial interests in nongovernment pension funds.* Stock held by a pension fund shall be considered owned by the beneficiaries of the fund equally on a pro-rata basis if—

(i) The pension fund meets the requirements of paragraph (b)(5)(iii) of this section;

(ii) The trustees, directors or other administrators of the pension fund have no knowledge, and no reason to know, that a pro-rata allocation of interests of the fund to all beneficiaries would differ significantly from an actuarial allocation of interests in the fund (or, if the beneficiaries' actuarial interest in the stock held directly or indirectly by the pension fund differs from the beneficiaries' actuarial interest in the pension fund, the actuarial interests computed by reference to the beneficiaries' actuarial interest in the stock);

(iii) Either—

(A) Any overfunding of the pension fund would be payable, pursuant to the governing instrument or the laws of the foreign country in which the pension fund is administered, only to, or for the benefit of, one or more corporations that are organized in the country in which the pension fund is administered, individual beneficiaries of the pension fund or their designated beneficiaries, or social or charitable causes (the reduction of the obligation of the sponsoring company or companies to make future contributions to the pension fund by reason of overfunding shall not itself result in such overfunding being deemed to be payable to or for the benefit of such company or companies); or

(B) The foreign country in which the pension fund is administered has laws that are designed to prevent overfunding of a pension fund and the funding of the pension fund is within the guidelines of such laws; or

(C) The pension fund is maintained to provide benefits to employees in a particular industry, profession, or group of industries or professions and employees of at least 10 companies (other than companies that are owned or controlled, directly or indirectly, by the same interests) contribute to the pension fund or receive benefits from the pension fund; and

(iv) The trustees, directors or other administrators provide the relevant documentation as required in paragraph (d) of this section.

(d) *Substantiation of stock ownership*—(1) *General rule.* A foreign corporation that relies on this section to satisfy the stock ownership test of §1.883–1(c)(2), must establish all the facts necessary to satisfy the Commissioner that more than 50 percent of the value of its shares is owned, or treated as owned applying paragraph (c) of this section, by qualified shareholders for the relevant period. If a foreign corporation relies upon bearer shares in the chain of ownership to satisfy one of the stock ownership tests, the foreign corporation must also establish all of the facts necessary to satisfy the Commissioner that such shares are maintained in a dematerialized book-entry system, as described in §1.883–1(c)(3)(i)(G), for the benefit of the relevant shareholder.

(2) *Application of general rule*—(i) *Ownership statements.* Except as provided in paragraph (d)(3) of this section, a person shall only be treated as a qualified shareholder of a foreign corporation if—

(A) For the relevant period, the person completes an ownership statement described in paragraph (d)(4) of this section or has a valid ownership statement in effect under paragraph (d)(2)(ii) of this section;

(B) In the case of a person owning stock in the foreign corporation indirectly through one or more intermediaries (including mere legal owners or recordholders acting as nominees), each intermediary in the chain of ownership between that person and the foreign corporation seeking qualified foreign corporation status completes an intermediary ownership statement described in paragraph (d)(4)(v) of this section or has a valid intermediary

ownership statement in effect under paragraph (d)(2)(ii) of this section; and

(C) The foreign corporation seeking qualified foreign corporation status obtains the statements described in paragraphs (d)(2)(i)(A) and (B) of this section.

(ii) *Three-year period of validity.* The ownership statements required in paragraph (d)(2)(i) of this section shall remain valid until the earlier of the last day of the third calendar year following the year in which the ownership statement is signed, or the day that a change of circumstance occurs that makes any information on the ownership statement incorrect. For example, an ownership statement signed on September 30, 2000, remains valid through December 31, 2003, unless a change of circumstance occurs that makes any information on the ownership statement incorrect.

(3) *Special rules*—(i) *Substantiating residence of certain shareholders.* A foreign corporation seeking qualified foreign corporation status or an intermediary that is a direct or indirect shareholder of such foreign corporation may substantiate the residence of certain shareholders, for purposes of paragraph (b)(2)(i)(B) of this section, under one of the following special rules in paragraphs (d)(3)(ii) through (viii) of this section, in lieu of obtaining the ownership statements required in paragraph (d)(2)(i) of this section from such shareholders.

(ii) *Special rule for registered shareholders owning less than one percent of widely-held corporations.* A foreign corporation with at least 250 registered shareholders, that is not a publicly-traded corporation, as described in §1.883–2 (a widely-held corporation), is not required to obtain an ownership statement from an individual shareholder owning less than one percent of the widely-held corporation at all times during the taxable year if the requirements of paragraphs (d)(3)(ii)(A) and (B) of this section are satisfied. If the widely-held foreign corporation is the foreign corporation seeking qualified foreign corporation status, or an intermediary that meets the documentation requirements of paragraphs (d)(4)(v)(A) and (B) of this section, the widely-held foreign corporation may treat the address of record in its ownership records as the residence of any less than one percent individual shareholder if—

(A) The individual's address of record is a specific street address and not a nonresidential address, such as a post office box or in care of a financial intermediary or stock transfer agent; and

(B) The officers and directors of the widely-held corporation neither know nor have reason to know that the individual does not reside at that address.

(iii) *Special rule for beneficiaries of pension funds*—(A) *Government pension fund.* An individual who is a beneficiary of a government pension fund, as defined in paragraph (b)(5)(ii) of this section, may be treated as a resident of the country in which the pension fund is administered if the pension fund satisfies the documentation requirements of paragraphs (d)(4)(v)(A) and (C)(*1*) of this section.

(B) *Nongovernment pension fund.* An individual who is a beneficiary of a nongovernment pension fund, as described in paragraph (b)(5)(iii) of this section, may be treated as a resident of the country of the beneficiary's address as it appears on the records of the fund, provided it is not a nonresidential address, such as a post office box or an address in care of a financial intermediary, and provided none of the trustees, directors or other administrators of the pension fund know, or have reason to know, that the beneficiary is not an individual resident of such foreign country. The rules of this paragraph (d)(3)(iii)(B) shall apply only if the nongovernment pension fund satisfies the documentation requirements of paragraphs (d)(4)(v)(A) and (C)(*2*) of this section.

(iv) *Special rule for stock owned by publicly-traded corporations.* Any stock in a foreign corporation seeking qualified foreign corporation status that is owned by a publicly-traded corporation will be treated as owned by an individual resident in the country where the publicly-traded corporation is organized if the foreign corporation receives the statement described in paragraph (d)(4)(iii) of this section from the publicly-traded corporation and copies of any relevant ownership statements

from shareholders of the publicly-traded corporation relied on to satisfy the exception to the closely-held test of §1.883–2(d)(3)(ii), as required in paragraph (d)(2)(i) of this section.

(v) *Special rule for not-for-profit organizations.* For purposes of meeting the ownership requirements of paragraph (a) of this section, a not-for-profit organization may rely on the addresses of record of its individual beneficiaries and supporters to determine the residence of an individual beneficiary or supporter, within the meaning of paragraph (b)(2)(i)(B) of this section, to the extent required under paragraph (b)(4) of this section, provided that—

(A) The addresses of record are not nonresidential addresses such as a post office box or in care of a financial intermediary;

(B) The officers, directors or administrators of the organization do not know or have reason to know that the individual beneficiaries or supporters do not reside at that address; and

(C) The foreign corporation seeking qualified foreign corporation status receives the statement required in paragraph (d)(4)(iv) of this section from the not-for-profit organization.

(vi) *Special rule for a foreign airline covered by an air services agreement.* A foreign airline that is covered by a bilateral Air Services Agreement in force between the United States and the qualified foreign country in which the airline is organized may rely exclusively on the Air Services Agreement currently in effect and will not have to otherwise substantiate its ownership under this section, provided that the United States has not waived the ownership requirements in the agreement or that the ownership requirements have not otherwise been made ineffective. Such an airline will be treated as owned by qualified shareholders resident in the country where the foreign airline is organized.

(vii) *Special rule for taxable nonstock corporations.* Any stock in a foreign corporation seeking qualified foreign corporation status that is owned by a taxable nonstock corporation will be treated as owned, in any taxable year, by the recipients of distributions made during that taxable year, as set out in paragraph (c)(5) of this section. The taxable nonstock corporation may treat the address of record in its distribution records as the residence of any recipient if—

(A) An individual recipient's address is in a qualified foreign country and is a specific street address and not a nonresidential address, such as a post office box or in care of a financial intermediary or stock transfer agent;

(B) The address of a nonindividual recipient's principal place of business is in a qualified foreign country;

(C) The officers and directors of the taxable nonstock corporation neither know nor have reason to know that the recipients do not reside or have their principal place of business at such addresses; and

(D) The foreign corporation receives the statement described in paragraph (d)(4)(v)(D) of this section from the taxable nonstock corporation intermediary.

(viii) *Special rule for closely-held corporations traded in the United States.* To demonstrate that a class of stock is not closely-held for purposes of §1.883–2(d)(3)(i), a foreign corporation whose stock is traded on an established securities market in the United States may rely on current Schedule 13D and Schedule 13G filings with the Securities and Exchange Commission to identify its 5-percent shareholders in each class of stock relied upon to meet the regularly traded test, without having to make any independent investigation to determine the identity of the 5-percent shareholder. However, if any class of stock is determined to be closely-held within the meaning of §1.883–2(d)(3)(i), the publicly traded corporation cannot satisfy the requirements of §1.883–2(e) unless it obtains sufficient documentation described in this paragraph (d) to demonstrate that the requirements of §1.883–2(d)(3)(ii) are met with respect to the 5-percent shareholders.

(4) *Ownership statements from shareholders*—(i) *Ownership statements from individuals.* An ownership statement from an individual is a written statement signed by the individual under penalties of perjury stating—

(A) The individual's name, permanent address, and country where the individual is fully liable to tax as a resident, if any;

(B) If the individual was not a resident of the country for the entire taxable year of the foreign corporation seeking qualified foreign corporation status, each of the foreign countries in which the individual resided and the dates of such residence during the taxable year of such foreign corporation;

(C) If the individual directly owns shares of stock in the corporation seeking qualified foreign corporation status, the name of the corporation, the number of shares in each class of stock of the corporation owned by the individual, whether any such shares are issued in bearer form and maintained in a dematerialized or immobilized book-entry system, as described in §1.883–1(c)(3)(i)(G), and the period (or periods) in the taxable year of the foreign corporation during which the individual owned the shares;

(D) If the individual directly owns an interest in a corporation, partnership, trust, estate, or other intermediary that directly or indirectly owns stock in the corporation seeking qualified foreign corporation status, the name of the intermediary, the number and class of shares or the amount and nature of the interest that the individual holds in such intermediary, and, if the intermediary is a corporation, whether any such shares are issued in bearer form and maintained in a dematerialized or immobilized book-entry system, as described in §1.883–1(c)(3)(i)(G), and the period (or periods) in the taxable year of the foreign corporation seeking qualified foreign corporation status during which the individual held such interest;

(E) To the extent known by the individual, a description of the chain of ownership through which the individual owns stock in the corporation seeking qualified foreign corporation status, including the name and address of each intermediary standing between the intermediary described in paragraph (d)(4)(i)(D) of this section and the foreign corporation and whether this interest is owned either directly or indirectly through bearer shares; and

(F) Any other information as specified in guidance published by the Internal Revenue Service (see §601.601(d)(2) of this chapter).

(ii) *Ownership statements from foreign governments.* An ownership statement from a foreign government that is a qualified shareholder is a written statement—

(A) Signed by any one of the following—

(*1*) An official of the governmental authority, agency or office who has supervisory authority with respect to the government's ownership interest and who is authorized to sign such a statement on behalf of the authority, agency or office; or

(*2*) The competent authority of the foreign country (as defined in the income tax convention between the United States and the foreign country); or

(*3*) An income tax return preparer that, for purposes of this paragraph (d)(4)(ii) only, shall mean a firm of licensed or certified public accountants, a law firm whose principals or members are admitted to practice in one or more states, territories or possessions of the United States or the country of such government, or a bank or other financial institution licensed to do business in such foreign country and having assets at least equivalent to 50 million U.S. dollars and who is authorized to represent the government or governmental authority; and

(B) That provides—

(*1*) The title of the official or other person signing the statement;

(*2*) The name and address of the government authority, agency or office that has supervisory authority and, if applicable, the income tax preparer which has prepared such ownership statement;

(*3*) The information described in paragraphs (d)(4)(i)(C) through (E) of this section (as if the language applied ''government'' instead of ''individual'') with respect to the government's direct or indirect ownership of stock in the corporation seeking qualified resident status;

(*4*) In the case of an ownership statement prepared by an income tax return preparer, a statement under penalties

of perjury identifying the documentation relied upon in the conduct of due diligence for the taxable year to determine the aggregate government investment in the stock of the shipping or aircraft company in preparation of such ownership statement attached to a valid power of attorney to represent the taxpayer for the taxable year; and

(*5*) Any other information as specified in guidance published by the Internal Revenue Service (see § 601.601(d)(2) of this chapter).

(iii) *Ownership statements from publicly-traded corporate shareholders.* An ownership statement from a publicly-traded corporation that is a direct or indirect owner of the corporation seeking qualified foreign corporation status is a written statement, signed under penalties of perjury by a person that would be authorized to sign a tax return on behalf of the shareholder corporation containing the following information—

(A) The name of the country in which the stock is primarily traded;

(B) The name of the established securities market or markets on which the stock is listed;

(C) A description of each class of stock relied upon to meet the requirements of § 1.883–2(d)(1), including the number of shares issued and outstanding as of the close of the taxable year;

(D) For each class of stock relied upon to meet the requirements of § 1.883–2(d)(1), if one or more 5-percent shareholders, as defined in § 1.883–2(d)(3)(i), own in the aggregate 50 percent or more of the vote and value of the outstanding shares of that class of stock for more than half the number of days during the taxable year—

(*1*) The days during the taxable year of the corporation in which the stock was closely-held without regard to the exception in paragraph (d)(3)(ii) of this section and the percentage of the vote and value of the class of stock that is owned by 5-percent shareholders during such days;

(*2*) For each qualified shareholder who owns or is treated as owning stock in the closely-held block upon whom the corporation intends to rely to satisfy the exception to the closely-held test of § 1.883–2(d)(3)(ii)—

(*i*) The name of each such shareholder;

(*ii*) The percentage of the total value of the class of stock held by each such shareholder and the days during which the stock was held;

(*iii*) The address of record of each such shareholder; and

(*iv*) The country of residence of each such shareholder, determined under paragraph (b)(2) or (d)(3) of this section;

(E) The information described in paragraphs (d)(4)(i)(C) through (E) of this section (as if the language applied ''publicly-traded corporation'' instead of ''individual'') with respect to the publicly-traded corporation's direct or indirect ownership of stock in the corporation seeking qualified resident status; and

(F) Any other information as specified in guidance published by the Internal Revenue Service (see § 601.601(d)(2) of this chapter).

(iv) *Ownership statements from not-for-profit organizations.* An ownership statement from a not-for-profit organization (other than a pension fund as defined in paragraph (b)(5) of this section) is a written statement signed by a person authorized to sign a tax return on behalf of the organization under penalties of perjury stating—

(A) The name, permanent address, and principal location of the activities of the organization (if different from its permanent address);

(B) The information described in paragraphs (d)(4)(i)(C) through (E) of this section (as if the language applied ''not-for-profit organization'' instead of ''individual'');

(C) A representation that the not-for-profit organization satisfies the requirements of paragraph (b)(4) of this section; and

(D) Any other information as specified in guidance published by the Internal Revenue Service (see § 601.601(d)(2) of this chapter).

(v) *Ownership statements from intermediaries*—(A) *General rule.* The foreign corporation seeking qualified foreign corporation status under the shareholder stock ownership test must obtain an intermediary ownership statement from each intermediary standing in the chain of ownership between it

and the qualified shareholders on whom it relies to meet this test. An intermediary ownership statement is a written statement signed under penalties of perjury by the intermediary (if the intermediary is an individual) or a person who would be authorized to sign a tax return on behalf of the intermediary (if the intermediary is not an individual) containing the following information—

(*1*) The name, address, country of residence, and principal place of business (in the case of a corporation or partnership) of the intermediary, and, if the intermediary is a trust or estate, the name and permanent address of all trustees or executors (or equivalent under foreign law), or if the intermediary is a pension fund, the name and permanent address of place of administration of the intermediary;

(*2*) The information described in paragraphs (d)(4)(i)(C) through (E) of this section (as if the language applied ''intermediary'' instead of ''individual'');

(*3*) If the intermediary is a nominee for a shareholder or another intermediary, the name and permanent address of the shareholder, or the name and principal place of business of such other intermediary;

(*4*) If the intermediary is not a nominee for a shareholder or another intermediary, the name and country of residence (within the meaning of paragraph (b)(2) of this section) and the proportionate interest in the intermediary of each direct shareholder, partner, beneficiary, grantor, or other interest holder (or if the direct holder is a nominee, of its beneficial shareholder, partner, beneficiary, grantor, or other interest holder), on which the foreign corporation seeking qualified foreign corporation status intends to rely to satisfy the requirements of paragraph (a) of this section. In addition, such intermediary must obtain from all such persons an ownership statement that includes the period of time during the taxable year for which the interest in the intermediary was owned by the shareholder, partner, beneficiary, grantor or other interest holder. For purposes of this paragraph (d)(4)(v)(A), the proportionate interest of a person in an intermediary is the percentage interest (by value) held by such person, determined using the principles for attributing ownership in paragraph (c) of this section;

(*5*) If the intermediary is a widely-held corporation with registered shareholders owning less than one percent of the stock of such widely-held corporation, the statement set out in paragraph (d)(4)(v)(B) of this section, relating to ownership statements from widely-held intermediaries with registered shareholders owning less than one percent of such widely-held intermediaries;

(*6*) If the intermediary is a pension fund, within the meaning of paragraph (b)(5) of this section, the statement set out in paragraph (d)(4)(v)(C) of this section, relating to ownership statements from pension funds;

(*7*) If the intermediary is a taxable nonstock corporation, within the meaning of paragraph (c)(5) of this section, the statement set out in paragraph (d)(4)(v)(D) of this section, relating to ownership statements from intermediaries that are taxable nonstock corporations; and

(*8*) Any other information as specified in guidance published by the Internal Revenue Service (see §601.601(d)(2) of this chapter).

(B) *Ownership statements from widely-held intermediaries with registered shareholders owning less than one percent of such widely-held intermediary*. An ownership statement from an intermediary that is a corporation with at least 250 registered shareholders, but that is not a publicly-traded corporation within the meaning of §1.883–2, and that relies on paragraph (d)(3)(ii) of this section, relating to the special rule for registered shareholders owning less than one percent of widely-held corporations, must provide the following information in addition to the information required in paragraph (d)(4)(v)(A) of this section—

(*1*) The aggregate proportionate interest by country of residence in the widely-held corporation of such registered shareholders or other interest holders whose address of record is a specific street address and not a nonresidential address, such as a post office box or in care of a financial intermediary or stock transfer agent; and

(*2*) A representation that the officers and directors of the widely-held intermediary neither know nor have reason to know that the individual shareholder does not reside at his or her address of record in the corporate records; and

(*3*) Any other information as specified in guidance published by the Internal Revenue Service (see § 601.601(d)(2) of this chapter).

(C) *Ownership statements from pension funds*—(*1*) *Ownership statements from government pension funds.* A government pension fund (as defined in paragraph (b)(5)(ii) of this section) that relies on paragraph (d)(3)(iii) of this section (relating to the special rules for pension funds) generally must provide the documentation required in paragraph (d)(4)(v)(A) of this section, and, in addition, the government pension fund must also provide the following information—

(*i*) The name of the country in which the plan is administered;

(*ii*) A representation that the fund is established exclusively for the benefit of employees or former employees of a foreign government, or employees or former employees of a foreign government and nongovernmental employees or former employees that perform or performed governmental or social services;

(*iii*) A representation that the funds that comprise the trust are managed by trustees who are employees of, or persons appointed by, the foreign government;

(*iv*) A representation that the trust forming part of the pension plan provides for retirement, disability, or death benefits in consideration for prior services rendered;

(*v*) A representation that the income of the trust satisfies the obligations of the foreign government to the participants under the plan, rather than inuring to the benefit of a private person; and

(*vi*) Any other information as specified in guidance published by the Internal Revenue Service (see § 601.601(d)(2) of this chapter).

(*2*) *Ownership statements from nongovernment pension funds.* The trustees, directors, or other administrators of the nongovernment pension fund, as defined in paragraph (b)(5)(iii) of this section, that rely on paragraph (d)(3)(iii) of this section, relating to the special rules for pension funds, generally must provide the pension fund's intermediary ownership statement described in paragraph (d)(4)(v)(A) of this section. In addition, the nongovernment pension fund must also provide the following information—

(*i*) The name of the country in which the pension fund is administered;

(*ii*) A representation that the pension fund is subject to supervision or regulation by a governmental authority (or other authority delegated to perform such supervision or regulation by a governmental authority) in such country, and, if so, the name of the governmental authority (or other authority delegated to perform such supervision or regulation);

(*iii*) A representation that the pension fund is generally exempt from income taxation in its country of administration;

(*iv*) The number of beneficiaries in the pension plan;

(*v*) The aggregate percentage interest of beneficiaries by country of residence based on addresses shown on the books and records of the fund, provided the addresses are not nonresidential addresses, such as a post office box or an address in care of a financial intermediary, and provided none of the trustees, directors or other administrators of the pension fund know, or have reason to know, that the beneficiary is not a resident of such foreign country;

(*vi*) A representation that the pension fund meets the requirements of paragraph (b)(5)(iii) of this section;

(*vii*) A representation that the trustees, directors or other administrators of the pension fund have no knowledge, and no reason to know, that a pro-rata allocation of interests of the fund to all beneficiaries would differ significantly from an actuarial allocation of interests in the fund (or, if the beneficiaries' actuarial interest in the stock held directly or indirectly by the pension fund differs from the beneficiaries' actuarial interest in the pension fund, the actuarial interests computed by reference to the beneficiaries' actuarial interest in the stock);

(*viii*) A representation that any overfunding of the pension fund would be payable, pursuant to the governing instrument or the laws of the foreign country in which the pension fund is administered, only to, or for the benefit of, one or more corporations that are organized in the country in which the pension fund is administered, individual beneficiaries of the pension fund or their designated beneficiaries, or social or charitable causes (the reduction of the obligation of the sponsoring company or companies to make future contributions to the pension fund by reason of overfunding shall not itself result in such overfunding being deemed to be payable to or for the benefit of such company or companies); or that the foreign country in which the pension fund is administered has laws that are designed to prevent overfunding of a pension fund and the funding of the pension fund is within the guidelines of such laws; or that the pension fund is maintained to provide benefits to employees in a particular industry, profession, or group of industries or professions, and that employees of at least 10 companies (other than companies that are owned or controlled, directly or indirectly, by the same interests) contribute to the pension fund or receive benefits from the pension fund; and

(*ix*) Any other information as specified in guidance published by the Internal Revenue Service (see §601.601(d)(2) of this chapter).

(*3*) *Time for making determinations.* The determinations required to be made under this paragraph (d)(4)(v)(C) shall be made using information shown on the records of the pension fund for a date during the foreign corporation's taxable year to which the determination is relevant.

(D) *Ownership statements from taxable nonstock corporations.* An ownership statement from an intermediary that is a taxable nonstock corporation must provide the following information in addition to the information required in paragraph (d)(4)(v)(A) of this section—

(*1*) With respect to paragraph (d)(4)(v)(A)(*7*) of this section, for each beneficiary that is treated as a qualified shareholder, the name, address of residence (in the case of an individual beneficiary, the address must be a specific street address and not a nonresidential address, such as a post office box or in care of a financial intermediary; in the case of a nonindividual beneficiary, the address of the principal place of business) and percentage that is the same proportion as the amount that the beneficiary receives in the tax year bears to the total net income of the taxable nonstock corporation in the tax year;

(*2*) A representation that the officers and directors of the taxable nonstock corporation neither know nor have reason to know that the individual beneficiaries do not reside at the address listed in paragraph (d)(4)(v)(D)(*1*) of this section or that any other nonindividual beneficiary does not conduct its primary activities at such address or in such country of residence; and

(*3*) Any other information as specified in guidance published by the Internal Revenue Service (see §601.601(d)(2) of this chapter).

(5) *Availability and retention of documents for inspection.* The documentation described in paragraphs (d)(3) and (4) of this section must be retained by the corporation seeking qualified foreign corporation status (the foreign corporation) until the expiration of the statute of limitations for the taxable year of the foreign corporation to which the documentation relates. Such documentation must be made available for inspection by the Commissioner at such time and place as the Commissioner may request in writing.

(e) *Reporting requirements.* A foreign corporation relying on the qualified shareholder stock ownership test of this section to meet the stock ownership test of §1.883–1(c)(2) must provide the following information in addition to the information required in §1.883–1(c)(3) to be included in its Form 1120–F, ''U.S. Income Tax Return of a Foreign Corporation,'' for each taxable year. The information should be current as of the end of the corporation's taxable year. The information must include the following—

(1) A representation that more than 50 percent of the value of the outstanding shares of the corporation is owned (or treated as owned by reason of paragraph (c) of this section) by

qualified shareholders for each category of income for which the exemption is claimed;

(2) With respect to all qualified shareholders relied upon to satisfy the 50 percent ownership test of paragraph (a) of this section, the total number of such qualified shareholders as defined in paragraph (b)(1) of this section; the total percentage of the value of the outstanding shares owned, applying the attribution rules of paragraph (c) of this section, by such qualified shareholders by country of residence or organization, whichever is applicable; and the period during the taxable year of the foreign corporation that such stock was held by qualified shareholders; and

(3) Any other relevant information specified by the Form 1120–F, ''U.S. Income Tax Return of a Foreign Corporation,'' and its accompanying instructions, or in published guidance by the Internal Revenue Service (see § 601.601(d)(2) of this chapter).

[T.D. 9087, 68 FR 51406, Aug. 26, 2003; 69 FR 7995, Feb. 20, 2004, as amended by T.D. 9332, 72 FR 34608, June 25, 2007; T.D. 9502, 75 FR 56865, Sept. 17, 2010]

§ 1.883–5 Effective/applicability dates.

(a) *General rule*. Sections 1.883–1 through 1.883–4 apply to taxable years of a foreign corporation seeking qualified foreign corporation status beginning after September 24, 2004.

(b) *Election for retroactive application*. Taxpayers may elect to apply §§ 1.883–1 through 1.883–4 for any open taxable year of the foreign corporation beginning after December 31, 1986, except that the substantiation and reporting requirements of § 1.883–1(c)(3) (relating to the substantiation and reporting required to be treated as a qualified foreign corporation) or §§ 1.883–2(f), 1.883–3(d) and 1.883–4(e) (relating to additional information to be included in the return to demonstrate whether the foreign corporation satisfies the stock ownership test) will not apply to any year beginning before September 25, 2004. Such election shall apply to the taxable year of the election and to all subsequent taxable years beginning before September 25, 2004.

(c) *Transitional information reporting rule*. For taxable years of the foreign corporation beginning after September 24, 2004, and until such time as the Form 1120–F, ''U.S. Income Tax Return of a Foreign Corporation,'' or its instructions are revised to provide otherwise, the information required in § 1.883–1(c)(3) and § 1.883–2(f), § 1.883–3(d) or § 1.883–4(e), as applicable, must be included on a wirtten statement attached to the Form 1120–F and file with the return.

(d) *Effective/applicability dates*. Except as otherwise provided in this paragraph (d), §§ 1.883–1, 1.883–2, 1.883–3, and 1.883–4 apply to taxable years of the foreign corporation beginning after June 25, 2007, and may be applied to any open taxable years of the foreign corporation beginning on or after December 31, 2004. The portion of any provision concerning bearer shares maintained in a dematerialized or immobilized book-entry system, as described in § 1.883–1(c)(3)(i)(G), applies to taxable years of a foreign corporation beginning on or after September 17, 2010.

[T.D. 9218, 70 FR 45530, Aug. 8, 2005, as amended by T.D. 9332, 72 FR 34609, June 25, 2007; T.D. 9502, 75 FR 56865, Sept. 17, 2010; 75 FR 63380, Oct. 15, 2010]

§ 1.884–0 Overview of regulation provisions for section 884.

(a) *Introduction*. Section 884 consists of three main parts: a branch profits tax on certain earnings of a foreign corporation's U.S. trade or business; a branch-level interest tax on interest paid, or deemed paid, by a foreign corporation's U.S. trade or business; and an anti-treaty shopping rule. A foreign corporation is subject to section 884 by virtue of owning an interest in a partnership, trust, or estate that is engaged in a U.S. trade or business or has income treated as effectively connected with the conduct of a trade or business in the United States. An international organization (as defined in section 7701(a)(18)) is not subject to the branch profits tax by reason of section 884(e)(5). A foreign government treated as a corporate resident of its country of residence under section 892(a)(3) shall be treated as a corporation for purposes of section 884. The preceding sentence shall be effective for taxable years ending on or after September 11, 1992, except that, for the

first taxable year ending on or after that date, the branch profits tax shall not apply to effectively connected earnings and profits of the foreign government earned prior to that date nor to decreases in the U.S. net equity of a foreign government occurring after the close of the preceding taxable year and before that date. Similarly, §1.884–4 shall apply, in the case of branch interest, only with respect to amounts of interest accrued and paid by a foreign government on or after that date, or, in the case of excess interest, only with respect to amounts attributable to interest accrued by a foreign government on or after that date and apportioned to ECI, as defined in §1.884–1(d)(1)(iii). Except as otherwise provided, for purposes of the regulations under section 884, the term ''U.S. trade or business'' includes all the U.S. trades or businesses of a foreign corporation.

(1) *The branch profits tax.* Section 1.884–1 provides rules for computing the branch profits tax and defines various terms that affect the computation of the tax. In general, section 884(a) imposes a 30-percent branch profits tax on the after-tax earnings of a foreign corporation's U.S. trade or business that are not reinvested in a U.S. trade or business by the close of the taxable year, or are disinvested in a later taxable year. Changes in the value of the equity of the foreign corporation's U.S. trade or business are used as the measure of whether earnings have been reinvested in, or disinvested form, a U.S. trade or business. An increase in the equity during the taxable year is generally treated as a reinvestment of the earnings for the current taxable year; a decrease in the equity during the taxable year is generally treated as a disinvestment of prior years' earnings that have not previously been subject to the branch profits tax. The amount subject to the branch profits tax for the taxable year is the dividend equivalent amount. Section 1.884–2T contains special rules relating to the effect on the branch profits tax of the termination or incorporation of a U.S. trade or business or the liquidation or reorganization of a foreign corporation or its domestic subsidiary.

(2) *The branch-level interest tax.* Section 1.884–4 provides rules for computing the branch-level interest tax. In general, interest paid by a U.S. trade or business of a foreign corporation (''branch interest'', as defined in §1.884–4(b)) is treated as if it were paid by a domestic corporation and may be subject to tax under section 871(a) or 881, and to withholding under section 1441 or 1442. In addition, if the interest apportioned to ECI exceeds branch interest, the excess is treated as interest paid to the foreign corporation by a wholly-owned domestic corporation and is subject to tax under section 881(a).

(3) *Qualified resident.* Section 1.884–5 provides rules for determining whether a foreign corporation is a qualified resident of a foreign country. In general, a foreign corporation must be a qualified resident of a foreign country with which the United States has an income tax treaty in order to claim an exemption or rate reduction with respect to the branch profits tax, the branch-level interest tax, and the tax on dividends paid by the foreign corporation.

(b) *Special rules for U.S. possessions.* (1) Section 884 does not apply to a corporation created or organized in, or under the law of, American Samoa, Guam, the Northern Mariana Islands, or the U.S. Virgin Islands, provided that the conditions of §1.881–5(c)(1) through (c)(3) are satisfied with respect to such corporation. The preceding sentence applies for taxable years ending after April 9, 2008.

(2) Section 884 does not apply for purposes of determining tax liability incurred to a section 935 possession or the U.S. Virgin Islands by a corporation created or organized in, or under the law of, such possession or the United States. The preceding sentence applies for taxable years ending after April 9, 2008.

(c) *Outline of major topics in §§1.884–1 through 1.884–5.*

§1.884–1 Branch profits tax.

(a) General rule.
(b) Dividend equivalent amount.
(1) Definition.
(2) Adjustment for increase in U.S. net equity.
(3) Adjustment for decrease in U.S. net equity.
(4) Examples.

(c) U.S. net equity.
(1) Definition.
(2) Definition of amount of a U.S. asset.
(3) Definition of determination date.
(d) U.S. assets.
(1) Definition of a U.S. asset.
(2) Special rules for certain assets.
(3) Interest in a partnership.
(4) Interest in a trust or estate.
(5) Property that is not a U.S. asset.
(6) E&P basis of a U.S. asset.
(e) U.S. liabilities.
(1) Liabilities based on § 1.882–5.
(2) Insurance reserves.
(3) Election to reduce liabilities.
(4) Artificial decrease in U.S. liabilities.
(5) Examples.
(f) Effectively connected earnings and profits.
(1) In general.
(2) Income that does not produce ECEP.
(3) Allocation of deductions attributable to income that does not produce ECEP.
(4) Examples.
(g) Corporations resident in countries with which the United States has an income tax treaty.
(1) General rule.
(2) Special rules for foreign corporations that are qualified residents on the basis of their ownership.
(3) Exemptions for foreign corporations resident in certain countries with income tax treaties in effect on January 1, 1987.
(4) Modifications with respect to other income tax treaties.
(5) Benefits under treaties other than income tax treaties.
(h) Stapled entities.
(i) Effective date.
(1) General rule.
(2) Election to reduce liabilities.
(3) Separate election for installment obligations.
(4) Special rule for certain U.S. assets and liabilities.
(j) Transition rules.
(1) General rule.
(2) Installment obligations.

§ 1.884–2T Special rules for termination or incorporation of a U.S. trade or business or liquidation or reorganization of a foreign corporation or its domestic subsidiary (temporary).

(a) Complete termination of a U.S. trade or business.
(1) General rule.
(2) Operating rules.
(3) Complete termination in the case of a section 338 election.
(4) Complete termination in the case of a foreign corporation with income under section 864(c)(6) or 864(c)(7).
(5) Special rule if a foreign corporation terminates an interest in a trust. [Reserved]
(6) Coordination with second-level withholding tax.
(b) Election to remain engaged in a U.S. trade or business.
(1) General rule.
(2) Marketable security.
(3) Identification requirements.
(4) Treatment of income from deemed U.S. assets.
(5) Method of election.
(6) Effective date.
(c) Liquidation, reorganization, etc., of a foreign corporation.
(1) Inapplicability of paragraph (a)(1) to section 381 (a) transactions.
(2) Transferor's dividend equivalent amount for the taxable year in which a section 381 (a) transaction occurs.
(3) Transferor's dividend equivalent amount for any taxable year succeeding the taxable year in which the section 381 (a) transaction occurs.
(4) Earnings and profits of the transferor carried over to the transferee pursuant to the section 381 (a) transaction.
(5) Determination of U.S. net equity of a transferee that is a foreign corporation.
(6) Special rules in the case of the disposition of stock or securities in a domestic transferee or in the transferor.
(d) Incorporation under section 351.
(1) In general.
(2) Inapplicability of paragraph (a)(1) of this section to section 351 transactions.
(3) Transferor's dividend equivalent amount for the taxable year in which a section 351 transaction occurs.
(4) Election to increase earnings and profits.
(5) Dispositions of stock or securities of the transferee by the transferor.
(6) Example.
(e) Certain transactions with respect to a domestic subsidiary.
(f) Effective date.

§ 1.884–3T Coordination of branch profits tax with second-tier withholding (temporary). [Reserved]

§ 1.884–4 Branch-level interest tax.

(a) General rule.
(1) Tax on branch interest.
(2) Tax on excess interest.
(3) Original issue discount.
(4) Examples.
(b) Branch interest.
(1) Definition of branch interest.
(2) [Reserved]
(3) Requirements relating to specifically identified liabilities.
(4) [Reserved]
(5) Increase in branch interest where U.S. assets constitute 80 percent or more of a foreign corporation's assets.

(6) Special rule where branch interest exceeds interest apportioned to ECI of a foreign corporation.
(7) Effect of election under paragraph (c)(1) of this section to treat interest as if paid in year of accrual.
(8) Effect of treaties.
(c) Rules relating to excess interest.
(1) Election to compute excess interest by treating branch interest that is paid and accrued in different years as if paid in year of accrual.
(2) Interest paid by a partnership.
(3) Effect of treaties.
(4) Examples.
(d) Stapled entities.
(e) Effective dates.
(1) General rule.
(2) Special rule.
(f) Transition rules.
(1) Election under paragraph (c)(1) of this section.
(2) Waiver of notification requirement for non-banks under Notice 89–80.
(3) Waiver of legending requirement for certain debt issued prior to January 3, 1989.

§ 1.884–5 Qualified resident.

(a) Definition of qualified resident.
(b) Stock ownership requirement.
(1) General rule.
(2) Rules for determining constructive ownership.
(3) Required documentation.
(4) Ownership statements from qualifying shareholders.
(5) Certificate of residency.
(6) Intermediary ownership statement.
(7) Intermediary verification statement.
(8) Special rules for pension funds.
(9) Availability of documents for inspection.
(10) Examples.
(c) Base erosion.
(d) Publicly-traded corporations.
(1) General rule.
(2) Established securities market.
(3) Primary traded.
(4) Regularly traded.
(5) Burden of proof for publicly-traded corporations.
(e) Active trade or business.
(1) General rule.
(2) Active conduct of a trade or business.
(3) Substantial presence test.
(4) Integral part of an active trade or business in the foreign corporation's country of residence.
(f) Qualified resident ruling.
(1) Basis for ruling.
(2) Factors.
(3) Procedural requirements.
(g) Effective dates.
(h) Transition rule.

[T.D. 8432, 57 FR 41649, Sept. 11, 1992; 57 FR 49117, Oct. 29, 1992; 57 FR 60126, Dec. 18, 1992, as amended by T.D. 8657, 61 FR 9338, Mar. 8, 1996; T.D. 9194, 70 FR 18930, Apr. 11, 2005; T.D. 9391, 73 FR 19360, Apr. 9, 2008; 73 FR 27728, May 14, 2008]

§ 1.884–1 Branch profits tax.

(a) *General rule.* A foreign corporation shall be liable for a branch profits tax in an amount equal to 30 percent of the foreign corporation's dividend equivalent amount for the taxable year. The branch profits tax shall be in addition to the tax imposed by section 882 and shall be reported on a foreign corporation's income tax return for the taxable year. The tax shall be due and payable as provided in section 6151 and such other provisions of Subtitle F of the Internal Revenue Code as apply to the income tax liability of corporations. However, no estimated tax payments shall be due with respect to a foreign corporation's liability for the branch profits tax. See paragraph (g) of this section for the application of the branch profits tax to corporations that are residents of countries with which the United States has an income tax treaty, and § 1.884–2T for the effect on the branch profits tax of the termination or incorporation of a U.S. trade or business, or the liquidation or reorganization of a foreign corporation or its domestic subsidiary.

(b) *Dividend equivalent amount*—(1) *Definition.* The term ''dividend equivalent amount'' means a foreign corporation's effectively connected earnings and profits (''ECEP'', as defined in paragraph (f)(1) of this section) for the taxable year, adjusted pursuant to paragraph (b) (2) or (3) of this section, as applicable. The dividend equivalent amount cannot be less than zero.

(2) *Adjustment for increase in U.S. net equity.* If a foreign corporation's U.S. net equity (as defined in paragraph (c) of this section) as of the close of the taxable year exceeds the foreign corporation's U.S. net equity as of the close of the preceding taxable year, then, for purposes of computing the foreign corporation's dividend equivalent amount for the taxable year, the foreign corporation's ECEP for the taxable year shall be reduced (but not

below zero) by the amount of such excess.

(3) *Adjustment for decrease in U.S. net equity*—(i) *In general*. Except as provided in paragraph (b)(3)(ii) of this section, if a foreign corporation's U.S. net equity as of the close of the taxable year is less than the foreign corporation's U.S. net equity as of the close of the preceding taxable year, then, for purposes of computing the foreign corporation's dividend equivalent amount for the taxable year, the foreign corporation's ECEP for the taxable year shall be increased by the amount of such difference.

(ii) *Limitation based on accumulated ECEP*. The increase of a foreign corporation's ECEP under paragraph (b)(3)(i) of this section shall not exceed the accumulated ECEP of the foreign corporation as of the beginning of the taxable year. The term ''accumulated ECEP'' means the aggregate amount of ECEP of a foreign corporation for preceding taxable years beginning after December 31, 1986, minus the aggregate dividend equivalent amounts for such preceding taxable years. Accumulated ECEP may be less than zero.

(4) *Examples*. The principles of paragraph (b) (2) and (3) of this section are illustrated by the following examples.

Example 1. Reinvestment of all ECEP. Foreign corporation A, a calendar year taxpayer, had $1,000 U.S. net equity as of the close of 1986 and $100 of ECEP for 1987. A acquires $100 of additional U.S. assets during 1987 and its U.S. net equity as of the close of 1987 is $1,100. In computing A's dividend equivalent amount for 1987, A's ECEP of $100 is reduced under paragraph (b)(2) of this section by the $100 increase in U.S. net equity between the close of 1986 and the close of 1987. A has no dividend equivalent amount for 1987.

Example 2. Partial reinvestment of ECEP. Assume the same facts as in *Example 1* except that A acquires $40 (rather than $100) of U.S. assets during 1987 and its U.S. net equity as of the close of 1987 is $1,040. In computing A's dividend equivalent amount for 1987, A's ECEP of $100 is reduced under paragraph (b)(2) of this section by the $40 increase in U.S. net equity between the close of 1986 and the close of 1987. A has a dividend equivalent amount of $60 for 1987.

Example 3. Disinvestment of prior year's ECEP. Assume the same facts as in *Example 1* for 1987. A has no ECEP for 1988. A's U.S. net equity decreases by $40 (to $1,060) as of the close of 1988. A has a dividend equivalent amount of $40 for 1988, even though it has no ECEP for 1988. A's ECEP of $0 for 1988 is increased under paragraph (b)(3)(i) of this section by the $40 reduction in U.S. net equity (subject to the limitation in paragraph (b)(3)(ii) of this section of $100 of accumulated ECEP).

Example 4. Accumulated ECEP limitation. Assume the same facts as in *Example 2* for 1987. For 1988, A has $125 of ECEP and its U.S. net equity decreases by $50. A's U.S. net equity as of the close of 1988 is $990 ($1,040–$50). In computing A's dividend equivalent amount for 1988, the $125 of ECEP for 1988 is not increased under paragraph (b)(3)(i) of this section by the full amount of the $50 decrease in U.S. net equity during 1988. Rather, the increase in ECEP resulting from the decrease in U.S. net equity is limited to A's accumulated ECEP as of the beginning of 1988. A had $100 of ECEP for 1987 and a dividend equivalent amount of $60 for that year, so A had $40 of accumulated ECEP as of the beginning of 1988. The increase in ECEP resulting from a decrease in U.S. net equity is thus limited to $40, and the dividend equivalent amount for 1988 is $165 ($125 ECEP + $40 decrease in U.S. net equity).

Example 5. Effect of deficits in ECEP. Foreign corporation A, a calendar year taxpayer, has $150 of accumulated ECEP as of the beginning of 1991 ($200 aggregate ECEP less $50 aggregate dividend equivalent amounts for years preceding 1991). A has U.S. net equity of $450 as of the close of 1990, U.S. net equity of $350 as of the close of 1991 (i.e., a $100 decrease in U.S. net equity) and a $90 deficit in ECEP for 1991. A's dividend equivalent amount is $10 for 1991, i.e., A's deficit of $90 in ECEP for 1991 increased by $100, the decrease in A's U.S. net equity during 1991. A portion of the reduction in U.S. net equity in 1991 ($90) is attributable to A's deficit in ECEP for that year. The reduction in U.S. net equity in 1991 ($100) triggers a dividend equivalent amount only to the extent it exceeds the $90 current year deficit in ECEP for 1991. As of the beginning of 1992, A has $50 of accumulated ECEP (i.e., $110 aggregate ECEP less $60 aggregate dividend equivalent amounts for years preceding 1992).

Example 6. Nimble dividend equivalent amount. Foreign corporation A, a calendar year taxpayer, had a deficit in ECEP of $100 for 1987 and $100 for 1988, and has $90 of ECEP for 1989. A had $2,000 U.S. net equity as of the close of 1988 and has $2,000 U.S. net equity as of the close of 1989. A has a dividend equivalent amount of $90 for 1989, its ECEP for the year, even though it has a net deficit of $110 in ECEP for the period 1987–1989.

(c) *U.S. net equity*—(1) *Definition*. The term ''U.S. net equity'' means the aggregate amount of the U.S. assets (as defined in paragraphs (c)(2) and (d)(1) of this section) of a foreign corporation as

of the determination date (as defined in paragraph (c)(3) of this section), reduced (including below zero) by the U.S. liabilities (as defined in paragraph (e) of this section) of the foreign corporation as of the determination date.

(2) *Definition of the amount of a U.S. asset*—(i) *In general*. For purposes of this section, the term ''amount of a U.S. asset'' means the U.S. asset's adjusted basis for purposes of computing earnings and profits (''E&P basis'') multiplied by the proportion of the asset that is treated as a U.S. asset under paragraphs (d) (1) through (4) of this section. The amount of a U.S. asset that is money shall be its face value. See paragraph (d)(6) of this section for rules concerning the computation of the E&P basis of a U.S. asset.

(ii) *Bad debt reserves*. A bank described in section 585(a)(2)(B) (without regard to the second sentence thereof) that uses the reserve method of accounting for bad debts for U.S. federal income tax purposes shall decrease the amount of loans that qualify as U.S. assets by any reserve that is permitted under section 585.

(3) *Definition of determination date*. For purposes of this section, the term ''determination date'' means the close of the day on which the amount of U.S. net equity is required to be determined. Unless otherwise provided, the U.S. net equity of a foreign corporation is required to be determined as of the close of the foreign corporation's taxable year.

(d) *U.S. assets*—(1) *Definition of a U.S. asset*—(i) *General rule*. Except as provided in paragraph (d)(5) of this section, the term ''U.S. asset'' means an asset of a foreign corporation (other than an interest in a partnership, trust, or estate) that is held by the corporation as of the determination date if—

(A) All income produced by the asset on the determination date is ECI (as defined in paragraph (d)(1)(iii) of this section) (or would be ECI if the asset produced income on that date); and

(B) All gain from the disposition of the asset would be ECI if the asset were disposed of on that date and the disposition produced gain.

For purposes of determining whether income or gain from an asset would be ECI under this paragraph (d)(1)(i), it is immaterial whether the asset is of a type that is unlikely to, or cannot, produce income or gain. For example, money may be a U.S. asset although it does not produce income or gain. In the case of an asset that does not produce income, however, the determination of whether income from the asset would be ECI shall be made under the principles of section 864 and the regulations thereunder, but without regard to §1.864–4(c)(2)(iii)(*b*). For purposes of determining whether an asset is a U.S. asset under this paragraph (d)(1), a foreign corporation may presume, unless it has reason to know otherwise, that gain from the sale of personal property (including inventory property) would be U.S. source if gain from the sale of that type of property would ordinarily be attributable to an office or other fixed place of business of the foreign corporation within the United States (within the meaning of section 865(e)(2)).

(ii) *Special rules for assets not described in paragraph (d)(1)(i) of this section*. An asset of a foreign corporation that is held by the corporation as of the determination date and is not described in paragraph (d)(1)(i) of this section shall be treated as a U.S. asset to the extent provided in paragraph (d)(2) of this section (relating to special rules for certain assets, including assets that produce income or gain at least a portion of which is ECI), and in paragraphs (d) (3) and (4) of this section (relating to special rules for interests in a partnership, trust, and estate).

(iii) *Definition of ECI*. For purposes of the regulations under section 884, the term ''ECI'' means income that is effectively connected with the conduct of a trade or business in the United States and income that is treated as effectively connected with the conduct of a trade or business in the United States under any provision of the Code. The term ''ECI'' also includes all income that is or is treated as effectively connected with the conduct of a U.S. trade or business whether or not the income is included in gross income (for example, interest income earned with respect to tax-exempt bonds).

(2) *Special rules for certain assets*—(i) *Depreciable and amortizable property*. An

item of depreciable personal property or an item of amortizable intangible property shall be treated as a U.S. asset of a foreign corporation in the same proportion that the amount of the depreciation or amortization with respect to the item of property that is allowable as a deduction, or is includible in cost of goods sold, for the taxable year in computing the effectively connected taxable income of the foreign corporation bears to the total amount of depreciation or amortization computed for the taxable year with respect to the item of property.

(ii) *Inventory*. An item or pool of inventory property (as defined in section 865(i)(1)) shall be treated as a U.S. asset in the same proportion as the amount of gross receipts from the sale or exchange of such property for the three preceding taxable years (or for such part of the three-year period as the corporation has been in existence) that is effectively connected with the conduct of a U.S. trade or business bears to the total amount of gross receipts from the sale or exchange of such property during such period (or part thereof). If a foreign corporation has not sold or exchanged such property during such three-year period (or part thereof), then the property shall be treated as a U.S. asset in the same proportion that the anticipated amount of gross receipts from the sale or exchange of the property that is reasonably anticipated to be ECI bears to the anticipated total amount of gross receipts from the sale or exchange of the property.

(iii) *Installment obligations*. An installment obligation received in connection with an installment sale (as defined in section 453(b)) for which an election under section 453(d) has not been made shall be treated as a U.S. asset to the extent that it is received in connection with the sale of a U.S. asset. If an obligation is received in connection with the sale of an asset that is wholly a U.S. asset, it shall be treated as a U.S. asset in its entirety. If a single obligation is received in connection with the sale of an asset that is in part a U.S. asset under the rules of paragraphs (d) (2) through (4) of this section, or in connection with the sale of several assets including one or more non-U.S. assets, the obligation shall be treated as a U.S. asset in the same proportion as—

(A) The sum of the amount of gain from the installment sale that would be ECI if the obligation were satisfied in full on the determination date and the adjusted basis of the obligation on such date (as determined under section 453B) attributable to the amount of gain that would be ECI bears to

(B) The sum of the total amount of gain from the sale if the obligation were satisfied in full and the adjusted basis of the obligation on such date (as determined under section 453B).

However, the obligation will only be treated as a U.S. asset if the interest income or original issue discount with respect to the obligation is ECI or the foreign corporation elects to treat the interest or original issue discount as ECI in the same proportion that the obligation is treated as a U.S. asset. A foreign corporation may elect to treat interest income or original issue discount as ECI by reporting such interest income or original issue discount as ECI on its income tax return or an amended return for the taxable year. See paragraph (d)(6)(ii) of this section to determine the E&P basis of an installment obligation for purposes of this paragraph (d)(2)(iii).

(iv) *Receivables*—(A) *Receivables arising from the sale or exchange of inventory property*. An account or note receivable (whether or not bearing stated interest) with a maturity not exceeding six months that arises from the sale or exchange of inventory property (as defined in section 865(i)(1)) shall be treated as a U.S. asset in the proportion determined under paragraph (d)(2)(iii) of this section as if the receivable were an installment obligation.

(B) *Receivables arising from the performance of services or leasing of property*. An account or note receivable (whether or not bearing stated interest) with a maturity not exceeding six months that arises from the performance of services or the leasing of property in the ordinary course of a foreign corporation's trade or business shall be treated as a U.S. asset in the same proportion that the amount of gross income represented by the receivable that is ECI bears to the total amount

of gross income represented by the receivable. For purposes of this paragraph (d)(2)(iv)(B), the amount of income represented by a receivable shall not include interest income or original issue discount.

(v) *Bank and other deposits.* A deposit or credit balance with a person described in section 871(i)(3) or a Federal Reserve Bank that is interest-bearing shall be treated as a U.S. asset if all income derived by the foreign corporation with respect to the deposit or credit balance during the taxable year is ECI. Any other deposit or credit balance shall only be treated as a U.S. asset if the deposit or credit balance is needed in a U.S. trade or business within the meaning of §1.864–4(c)(2)(iii)(*a*).

(vi) *Debt instruments.* A debt instrument, as defined in section 1275(a)(1) (other than an asset treated as a U.S. asset under any other subdivision of this paragraph (d)) shall be treated as a U.S. asset, notwithstanding the fact that gain from the sale or exchange of the obligation on the determination date would not be ECI, if—

(A) All income derived by the foreign corporation from such obligation during the taxable year is ECI; and

(B) The yield for the period that the instrument was held during the taxable year equals or exceeds the Applicable Federal Rate for instruments of similar type and maturity.

Shares in a regulated investment company that purchases solely instruments that, under this paragraph (d)(2)(vi), would be U.S. assets if held directly by the foreign corporation shall also be treated as a U.S. asset.

(vii) *Securities held by a foreign corporation engaged in a banking, financing or similar business.* Securities described in §1.864–4(c)(5)(ii)(*b*)(*3*) held by a foreign corporation engaged in the active conduct of a banking, financing, or similar business in the United States during the taxable year shall be treated as U.S. assets in the same proportion that income, gain, or loss from such securities is ECI for the taxable year under §1.864–4(c)(5)(ii).

(viii) *Federal income taxes.* An overpayment of Federal income taxes shall be treated as a U.S. asset to the extent that the tax would reduce a foreign corporation's ECEP for the taxable year but for the fact that the tax does not accrue during the taxable year.

(ix) *Losses involving U.S. assets.* A foreign corporation that sustains, with respect to a U.S. asset, a loss for which a deduction is not allowed under section 165 (in whole or in part) because there exists a reasonable prospect of recovering compensation for the loss shall be treated as having a U.S. asset (''loss property'') from the date of the loss in the same proportion that the asset was treated as a U.S. asset immediately before the loss. See paragraph (d)(6)(iv) of this section to determine the E&P basis of the loss property.

(x) *Ruling for involuntary conversion.* If property that is a U.S. asset of a foreign corporation is compulsorily or involuntarily converted into property not similar or related in service or use (within the meaning of section 1033), the foreign corporation may apply to the Commissioner for a ruling to determine its U.S. assets for the taxable year of the involuntary conversion.

(xi) *Examples.* The principles of paragraphs (c) and (d) (1) and (2) of this section are illustrated by the following examples.

Example 1. Depreciable property. Foreign corporation A, a calendar year taxpayer, is engaged in a trade or business in the United States. A owns equipment that is used in its manufacturing business in country X and in the United States. Under §1.861–8, A's depreciation deduction with respect to the equipment is allocated to sales income and is apportioned 70 percent to ECI and 30 percent to income that is not ECI. Under paragraph (d)(2)(ii) of this section, the equipment is 70 percent a U.S. asset. The equipment has an E&P basis of $100 at the beginning of 1993. A's depreciation deduction (for purposes of computing earnings and profits) with respect to the equipment is $10 for 1993. To determine the amount of A's U.S. asset at the close of 1993, the equipment's $90 E&P basis at the close of 1993 is multiplied by 70 percent (the proportion of the asset that is a U.S. asset). The amount of the U.S. asset as of the close of 1993 is $63.

Example 2. U.S. real property interest connected to a U.S. business. FC is a foreign corporation that is a bank, within the meaning of section 585(a)(2)(B) (without regard to the second sentence thereof), and is engaged in the business of taking deposits and making loans through its branch in the United States. In 1996, FC makes a loan in the ordinary course of its lending business in the United States, securing the loan with a

mortgage on the U.S. real property being financed by the borrower. In 1997, after the borrower has defaulted on the loan, FC takes title to the real property that secures the loan. On December 31, 1997, FC continues to hold the property, classifying it on its financial statement as *Other Real Estate Owned*. Because all income and gain from the property would be ECI to FC under the principles of section 864(c)(2), the U.S. real property constitutes a U.S. asset within the meaning of paragraph (d) of this section.

Example 3. U.S. real property interest not connected to a U.S. business. Foreign corporation A owns a condominium apartment in the United States. Assume that holding the apartment does not constitute a U.S. trade or business and the foreign corporation has not made an election under section 882(d) to treat income with respect to the property as ECI. The condominium apartment is not a U.S. asset of A because the income, if any, from the asset would not be ECI. However, the disposition by A of the condominium apartment at a gain will give rise to ECEP.

Example 4. Stock in a domestically-controlled REIT. As an investment, foreign corporation A owns stock in a domestically-controlled REIT, within the meaning of section 897(h)(4)(B). Under section 897(h)(2), gain on disposition of stock in the REIT is not treated as ECI. For this reason the stock does not qualify as a U.S. asset under paragraph (d)(1) of this section even if dividend distributions from the REIT are treated as ECI. Thus, A will have a dividend equivalent amount based on the ECEP attributable to a distribution of ECI from the REIT, even if A invests the proceeds from the dividend in additional stock of the REIT. (Stock in a REIT that is not a domestically-controlled REIT is also not a U.S. asset. See §1.884–1(d)(5)).

Example 5. Section 864(c)(7) property. Foreign corporation A is engaged in the equipment leasing business in the United States and Canada. A transfers the equipment leased by its U.S. trade or business to its Canadian business after the equipment is fully depreciated in the United States. The Canadian business sells the equipment two years later. Section 864(c)(7) would treat the gain on the disposition of the equipment by A as taxable under section 882 as if the sale occurred immediately before the equipment was transferred to the Canadian business. The equipment would not be treated as a U.S. asset even if the gain was ECI because the income from the equipment in the year of the sale in Canada would not be ECI.

(3) *Interest in a partnership*—(i) *In general.* A foreign corporation that is a partner in a partnership must take into account its interest in the partnership (and not the partnership assets) in determining its U.S. assets. For purposes of determining the proportion of the partnership interest that is a U.S. asset, a foreign corporation may elect to use either the asset method described in paragraph (d)(3)(ii) of this section or the income method described in paragraph (d)(3)(iii) of this section.

(ii) *Asset method*—(A) *In general.* A partner's interest in a partnership shall be treated as a U.S. asset in the same proportion that the sum of the partner's proportionate share of the adjusted bases of all partnership assets as of the determination date, to the extent that the assets would be treated as U.S. assets if the partnership were a foreign corporation, bears to the sum of the partner's proportionate share of the adjusted bases of all partnership assets as of the determination date. Generally a partner's proportionate share of a partnership asset is the same as its proportionate share of all items of income, gain, loss, and deduction that may be generated by the asset.

(B) *Non-uniform proportionate shares.* If a partner's proportionate share of all items of income, gain, loss, and deduction that may be generated by a single asset of the partnership throughout the period that includes the taxable year of the partner is not uniform, then, for purposes of determining the partner's proportionate share of the adjusted basis of that asset, a partner must take into account the portion of the adjusted basis of the asset that reflects the partner's economic interest in that asset. A partner's economic interest in an asset of the partnership must be determined by applying the following presumptions. These presumptions may, however, be rebutted if the partner or the Internal Revenue Service shows that the presumption is inconsistent with the partner's true economic interest in the asset during the corporation's taxable year.

(*1*) If a partnership asset ordinarily generates directly identifiable income, a partner's economic interest in the asset is determined by reference to its proportionate share of income that may be generated by the asset for the partnership's taxable year ending with or within the partner's taxable year.

(*2*) If a partnership asset ordinarily generates current deductions and ordinarily generates no directly identifiable income, for example because the asset contributes equally to the generation of all the income of the partnership (such as an asset used in general and administrative functions), a partner's economic interest in the asset is determined by reference to its proportionate share of the total deductions that may be generated by the asset for the partnership's taxable year ending with or within the partner's taxable year.

(*3*) For other partnership assets not described in paragraph (d)(3)(ii)(B) (*1*) or (*2*) of this section, a partner's economic interest in the asset is determined by reference to its proportionate share of the total gain or loss to which it would be entitled if the asset were sold at a gain or loss in the partnership's taxable year ending with or within the partner's taxable year.

(C) *Partnership election under section 754.* If a partnership files an election in accordance with section 754, then for purposes of this paragraph (d)(3)(ii), the basis of partnership property shall reflect adjustments made pursuant to sections 734 (relating to distributions of property to a partner) and 743 (relating to the transfer of an interest in a partnership). However, adjustments made pursuant to section 743 may be made with respect to a transferee partner only.

(iii) *Income method.* Under the income method, a partner's interest in a partnership shall be treated as a U.S. asset in the same proportion that its distributive share of partnership ECI for the partnership's taxable year that ends with or within the partner's taxable year bears to its distributive share of all partnership income for that taxable year.

(iv) *Manner of election*—(A) *In general.* In determining the proportion of a foreign corporation's interest in a partnership that is a U.S. asset, a foreign corporation must elect one of the methods described in paragraph (d)(3) of this section on a timely filed return for the first taxable year beginning on or after the effective date of this section. An amended return does not qualify for this purpose, nor shall the provisions of § 301.9100–1 of this chapter and any guidance promulgated thereunder apply. An election shall be made by the foreign corporation calculating its U.S. assets in accordance with the method elected. An elected method must be used for a minimum period of five years before the foreign corporation may elect a different method. To change an election before the end of the requisite five-year period, a foreign corporation must obtain the consent of the Commissioner or her delegate. The Commissioner or her delegate will generally consent to a foreign corporation's request to change its election only in rare and unusual circumstances. A foreign corporation that is a partner in more than one partnership is not required to elect to use the same method for each partnership interest.

(B) *Elections with tiered partnerships.* If a foreign corporation elects to use the asset method with respect to an interest in a partnership, and that partnership is a partner in a lower-tier partnership, the foreign corporation may apply either the asset method or the income method to determine the proportion of the upper-tier partnership's interest in the lower-tier partnership that is a U.S. asset.

(v) *Failure to make proper election.* If a foreign corporation, for any reason, fails to make an election to use one of the methods required by paragraph (d)(3) of this section in a timely fashion, the director of field operations or the Assistant Commissioner (International) may make the election on behalf of the foreign corporation and such election shall be binding as if made by that corporation.

(vi) *Special rule for determining a partner's adjusted basis in a partnership interest.* For purposes of paragraphs (d)(3) and (6) of this section, a partner's adjusted basis in a partnership interest shall be the partner's basis in such interest (determined under section 705) reduced by the partner's share of the liabilities of the partnership determined under section 752 and increased by a proportionate share of each liability of the partnership equal to the partner's proportionate share of the expense, for income tax purposes, attributable to such liability for the taxable year. A

partner's adjusted basis in a partnership interest cannot be less than zero.

(vii) *E&P basis of a partnership interest.* See paragraph (d)(6)(iii) of this section for special rules governing the calculation of a foreign corporation's E&P basis in a partnership interest.

(viii) The application of this paragraph (d)(3) is illustrated by the following examples:

Example 1. General rule. (i) *Facts.* Foreign corporation, FC, is a partner in partnership ABC, which is engaged in a trade or business within the United States. FC and ABC are both calendar year taxpayers. ABC owns and manages two office buildings located in the United States, each with an adjusted basis of $50. ABC also owns a non-U.S. asset with an adjusted basis of $100. ABC has no liabilities. Under the partnership agreement, FC has a 50 percent interest in the capital of ABC and a 50 percent interest in all items of income, gain, loss, and deduction that may be generated by the partnership's assets. FC's adjusted basis in ABC is $100. In determining the proportion of its interest in ABC that is a U.S. asset, FC elects to use the asset method described in paragraph (d)(3)(ii) of this section.

(ii) *Analysis.* FC's interest in ABC is treated as a U.S. asset in the same proportion that the sum of FC's proportionate share of the adjusted bases of all ABC's U.S. assets (50% of $100), bears to the sum of FC's proportionate share of the adjusted bases of all of ABC's assets (50% of $200). Under the asset method, the amount of FC's interest in ABC that is a U.S. asset is $50 ($100 × $50/$100).

Example 2. Special allocation of gain with respect to real property. (i) *Facts.* The facts are the same as in *Example 1,* except that under the partnership agreement, FC is allocated 20 percent of the income from the partnership property but 80 percent of the gain on disposition of the partnership property.

(ii) *Analysis.* Assuming that the buildings ordinarily generate directly identifiable income, there is a rebuttable presumption under paragraph (d)(3)(ii)(B)(*1*) of this section that FC's proportionate share of the adjusted basis of the buildings is FC's proportionate share of the income generated by the buildings (20%) rather than the total gain that it would be entitled to under the partnership agreement (80%) if the buildings were sold at a gain on the determination date. Thus, the sum of FC's proportionate share of the adjusted bases in ABC's U.S. assets (the buildings) is presumed to be $20 [(20% of $50) + (20% of $50)]. Assuming that the non-U.S. asset is not income-producing and does not generate current deductions, there is a rebuttable presumption under paragraph (d)(3)(ii)(B)(*3*) of this section that FC's proportionate share of the adjusted basis of that asset is FC's interest in the gain on the disposition of the asset (80%) rather than its proportionate share of the income that may be generated by the asset (20%). Thus, FC's proportionate share of the adjusted basis of ABC's non-U.S. asset is presumed to be $80 (80% of $100). FC's proportionate share of the adjusted bases of all of the assets of ABC is $100 ($20 + $80). The amount of FC's interest in ABC that is a U.S. asset is $20 ($100 × $20/$100).

Example 3. Tiered partnerships (asset method). (i) *Facts.* The facts are the same as in *Example 1,* except that FC's adjusted basis in ABC is $175 and ABC also has a 50 percent interest in the capital of partnership DEF. DEF owns and operates a commercial shopping center in the United States with an adjusted basis of $200 and also owns non-U.S. assets with an adjusted basis of $100. DEF has no liabilities. ABC's adjusted basis in its interest in DEF is $150 and ABC has a 50 percent interest in all the items of income, gain, loss and deduction that may be generated by the assets of DEF.

(ii) *Analysis.* Because FC has elected to use the asset method described in paragraph (d)(3)(ii) of this section, it must determine what proportion of ABC's partnership interest in DEF is a U.S. asset. As permitted by paragraph (d)(3)(iv)(B) of this section, FC also elects to use the asset method with respect to ABC's interest in DEF. ABC's interest in DEF is treated as a U.S. asset in the same proportion that the sum of ABC's proportionate share of the adjusted bases of all DEF's U.S. assets (50% of $200), bears to the sum of ABC's proportionate share of the adjusted bases of all of DEF's assets (50% of $300). Thus, the amount of ABC's interest in DEF that is a U.S. asset is $100 ($150 × $100/$150). FC must then apply the rules of paragraph (d)(3)(ii) of this section to all the assets of ABC, including ABC's interest in DEF that is treated in part as a U.S. asset ($100) and in part as a non-U.S. asset ($50). FC's interest in ABC is treated as a U.S. asset in the same proportion that the sum of FC's proportionate share of the adjusted bases of the U.S. assets of ABC (including ABC's interest in DEF), bears to the sum of FC's proportionate share of the adjusted bases of all ABC's assets (including ABC's interest in DEF). Thus, the amount of FC's interest in ABC that is a U.S. asset is $100 (FC's adjusted basis in ABC ($175) multiplied by FC's proportionate share of the sum of the adjusted bases of ABC's U.S. assets ($100)) over FC's proportionate share of the sum of the adjusted bases of ABC's assets ($175)).

Example 4. Tiered partnerships (income method). (i) *Facts.* The facts are the same as in *Example 3,* except that FC has elected to use the income method described in paragraph (d)(3)(iii) of this section to determine the proportion of its interest in ABC that is a U.S. asset. The two office buildings located

in the United States generate $60 of income that is ECI for the taxable year. The non-U.S. asset is not-income producing. In addition ABC's distributive share of income from DEF consists of $40 of income that is ECI and $140 of income that is not ECI.

(ii) *Analysis.* Because FC has elected to use the income method it does need to determine what proportion of ABC's partnership interest in DEF is a U.S. asset. FC's interest in ABC is treated as a U.S. asset in the same proportion that its distributive share of ABC's income for the taxable year that is ECI ($50) ($30 earned directly by ABC + $20 distributive share from DEF) bears to its distributive share of all ABC's income for the taxable year ($55) ($30 earned directly by ABC + $25 distributive share from DEF). Thus, FC's interest in ABC that is a U.S. asset is $159 ($175 × $50/$55).

(4) *Interest in a trust or estate*—(i) *Estates and non-grantor trusts.* A foreign corporation that is a beneficiary of a trust or estate shall not be treated as having a U.S. asset by virtue of its interest in the trust or estate.

(ii) *Grantor trusts.* If, under sections 671 through 678, a foreign corporation is treated as owning a portion of a trust that includes all the income and gain that may be generated by a trust asset (or pro rata portion of a trust asset), the foreign corporation will be treated as owning the trust asset (or pro rata portion thereof) for purposes of determining its U.S. assets under this section.

(5) *Property that is not a U.S. asset*—(i) *Property that does not give rise to ECEP.* Property described in paragraphs (d) (1) through (4) of this section shall not be treated as a U.S. asset of a foreign corporation if, on the determination date, income from the use of the property, or gain or loss from the disposition of the property, would be described in paragraph (f)(2) of this section (relating to certain income that does not produce ECEP).

(ii) *Assets acquired to increase U.S. net equity artificially.* U.S. assets shall not include assets acquired or used by a foreign corporation if one of the principal purposes of such acquisition or use is to increase artificially the U.S. assets of a foreign corporation on the determination date. Whether assets are acquired or used for such purpose will depend upon all the facts and circumstances of each case. Factors to be considered in determining whether one of the principal purposes in acquiring or using an asset is to increase artificially the U.S. assets of a foreign corporation include the length of time during which the asset was used in a U.S. trade or business, whether the asset was acquired from, or disposed of to, a related person, and whether the aggregate value of the U.S. assets of the foreign corporation increased temporarily on the determination date. For purposes of this paragraph (d)(5)(ii), to be one of the principal purposes, a purpose must be important, but it is not necessary that it be the primary purpose.

(iii) *Interbranch transactions.* A transaction of any type between separate offices or branches of the same taxpayer does not create a U.S. asset.

(6) *E&P basis of a U.S. asset*—(i) *General rule.* The E&P basis of a U.S. asset for purposes of this section is its adjusted basis for purposes of computing the foreign corporation's earnings and profits. In determining the E&P basis of a U.S. asset, the adjusted basis of the asset (for purposes of computing taxable income) must be increased or decreased to take into account inclusions of income or gain, and deductions or similar charges, that affect the basis of the asset where such items are taken into account in a different manner for purposes of computing earnings and profits than for purposes of computing taxable income. For example, if section 312 (k) requires that depreciation with respect to a U.S. asset be determined using the straight line method for purposes of computing earnings and profits, but depreciation with respect to the asset is determined using a different method for purposes of computing taxable income, the E&P basis of the property for purposes of this section must be computed using the straight line method of depreciation.

(ii) *Installment obligations*—(A) *Sales in taxable year beginning on or after January 1, 1987.* For purposes of this section, the E&P basis of an installment obligation described in paragraph (d)(2)(iii) of this section that arises in connection with an installment sale occurring in a taxable year beginning on or after January 1, 1987, shall equal the sum of the total amount of gain from the sale if the obligation were satisfied

in full and the adjusted basis of the property sold as of the date of sale, reduced by payments received with respect to the obligation that are not interest or original issue discount. See paragraph (j)(2)(ii) of this section, however, for a special E&P basis rule for an installment obligation arising in connection with a sale of a U.S. asset by a foreign corporation described in section 312(k)(4), where such sale occurs in a taxable year beginning in 1987.

(B) *Sales in taxable year prior to January 1, 1987.* For purposes of this section, the E&P basis of an installment obligation described in paragraph (d)(2)(iii) of this section that arises in connection with an installment sale occurring in a taxable year beginning before January 1, 1987, shall equal zero.

(iii) *Computation of E&P basis in a partnership.* For purposes of this section, a foreign corporation's E&P basis in a partnership interest shall be the foreign corporation's adjusted basis in such interest (as determined under paragraph (d)(3)(vi) of this section), further adjusted to take into account any differences between the foreign corporation's distributive share of items of partnership income, gain, loss, and deduction for purposes of computing the taxable income of the foreign corporation and the foreign corporation's distributive share of items of partnership income, gain, loss, and deductions for purposes of computing the earnings and profits of the foreign corporation.

(iv) *Computation of E&P basis of a loss property.* The E&P basis of a loss property (as defined in paragraph (d)(2)(ix) of this section) shall equal the E&P basis, immediately before the loss, of the U.S. asset with respect to which the loss was sustained, reduced (but not below zero) by—

(A) The amount of any deduction claimed under section 165 by the foreign corporation with respect to the loss for earnings and profits purposes; and

(B) Any compensation received with respect to the loss.

(v) *Computation of E&P basis of financial instruments.* [Reserved]

(vi) *Example.* The application of paragraph (d)(6)(ii) of this section is illustrated by the following example.

Example. Sale in taxable year beginning on or after January 1, 1987. Foreign corporation A, a calendar year taxpayer, sells a U.S. asset on the installment method in 1993. Under the terms of the sale, A is to receive $100, payable in ten annual installments of $10 beginning in 1994, plus an arm's-length rate of interest on the unpaid balance of the sales price. A's adjusted basis in the property sold is $70. The obligation received in connection with the installment sale is treated as a U.S. asset with an E&P basis of $100 ($30 (the amount of gain from the sale if the obligation were satisfied in full) + $70 (the adjusted basis of the property sold)). If A receives a payment of $10 (not including interest) in 1994 with respect to the obligation, the obligation is treated as a U.S. asset with an E&P basis of $90 ($100 − $10) as of the close of 1994.

(e) *U.S. liabilities.* The term *U.S. liabilities* means the amount of liabilities determined under paragraph (e)(1) of this section decreased by the amount of liabilities determined under paragraph (e)(3) of this section, and increased by the amount of liabilities determined under paragraph (e)(2) of this section.

(1) *Liabilities based on § 1.882–5.* The amount of liabilities determined under this paragraph (e)(1) is the amount of U.S.-connected liabilities of a foreign corporation under § 1.882–5 if the U.S.-connected liabilities were computed using the assets and liabilities of the foreign corporation as of the determination date (rather than the average of such assets and liabilities for the taxable year) and without regard to paragraph (e)(3) of this section.

(2) *Additional liabilities*—(i) *Insurance reserves.* The amount of liabilities determined under this paragraph (e)(2)(i) is the amount (as of the determination date) of the total insurance liabilities on United States business (within the meaning of section 842(b)(2)(B)) of a foreign corporation described in section 842(a) (relating to foreign corporations carrying on an insurance business in the United States) to the extent that such liabilities are not otherwise treated as U.S. liabilities by reason of paragraph (e)(1) of this section.

(ii) *Liabilities described in § 1.882–5(a)(1)(ii).* The amount of liabilities determined under this paragraph (e)(2)(ii) is the amount (as of the determination date) of liabilities described in § 1.882–5(a)(1)(ii) (relating to liabilities giving

rise to interest expense that is directly allocated to income from a U.S. asset).

(3) *Election to reduce liabilities*—(i) *General rule.* The amount of liabilities determined under this paragraph (e)(3) is the amount by which a foreign corporation elects to reduce its liabilities under paragraph (e)(1) of this section.

(ii) *Limitation.* For any taxable year, a foreign corporation may elect to reduce the amount of its liabilities determined under paragraph (e)(1) of this section by an amount that does not exceed the lesser of the amount of U.S. liabilities as of the determination date, or the amount of U.S. liability reduction needed to reduce a dividend equivalent amount as of the determination date to zero.

(iii) *Effect of election on interest deduction and branch-level interest tax.* A foreign corporation that elects to reduce its liabilities under this paragraph (e)(3) must, for purposes of computing the amount of its interest apportioned to ECI under §1.882–5, reduce its U.S.-connected liabilities for the taxable year of the election by the amount of the reduction in liabilities under this paragraph (e)(3). The reduction of its U.S.-connected liabilities will also require a corresponding decrease in the amount of its interest apportioned to ECI under §1.882–5 for purposes of §1.884–4(a) and for all other Code sections for which the amount of interest apportioned under §1.882–5 is relevant.

(iv) *Method of election.* A foreign corporation that elects the benefits of this paragraph (e)(3) for a taxable year shall attach a statement to its return for the taxable year that it has elected to reduce its liabilities for the taxable year under this paragraph (e)(3) and that it has reduced the amount of its U.S.-connected liabilities as provided in paragraph (e)(3)(iii) of this section and shall indicate the amount of such reductions on such attachment. The cumulative amount of all U.S. liability reductions is shown on Schedule I (Form 1120–F) in addition to the separate elections attached to the timely filed return. An election under this paragraph (e)(3) must be made before the due date (including extensions) for the foreign corporation's income tax return for the taxable year.

(v) *Effect of election on complete termination.* If a foreign corporation completely terminates its U.S. trade or business (within the meaning of §1.884–2T (a)(2)), notwithstanding §1.884–2T(a), the foreign corporation will be subject to tax on a dividend equivalent amount that equals the lesser of—

(A) The foreign corporation's accumulated ECEP that is attributable to an election to reduce liabilities; or

(B) The amount by which the corporation elected to reduce liabilities at the end of the taxable year preceding the year of complete termination.

For purposes of the preceding sentence, accumulated ECEP is attributable to an election to reduce liabilities to the extent that the ECEP was accumulated because of such an election rather than because of an increase in U.S. assets. For example, if a foreign corporation did not have positive ECEP in any year for which an election was made, it would not be required to include an amount as a dividend equivalent amount under this paragraph (e)(3)(v) because any accumulated ECEP that it may have is not attributable to an election to reduce liabilities.

(4) *Artificial decrease in U.S. liabilities.* If a foreign corporation repays or otherwise decreases its U.S. liabilities and one of the principal purposes of such decrease is to decrease artificially its U.S. liabilities on the determination date, then such decrease shall not be taken into account for purposes of computing the foreign corporation's U.S. net equity. Whether the U.S. liabilities of a foreign corporation are artificially decreased will depend on all the facts and circumstances of each case. Factors to be considered in determining whether one of the principal purposes for the repayment or decrease of the liabilities is to decrease artificially the U.S. liabilities of a foreign corporation shall include whether the aggregate liabilities are temporarily decreased on or before the determination date by, for example, the repayment of liabilities, or U.S. liabilities are temporarily decreased on or before the determination date by the acquisition with contributed funds of passive-type assets that are not U.S. assets. For purposes of this paragraph (e)(4), to

be one of the principal purposes, a purpose must be important, but it is not necessary that it be the primary purpose.

(5) *Examples*. The application of this paragraph (e) is illustrated by the following examples.

Example 1. General rule for computation of U.S. liabilities. As of the close of 1997, foreign corporation A, a calendar year taxpayer computes its U.S.-connected liabilities under §1.882–5(c) using its actual ratio of liabilities to assets. For purposes of computing its U.S.- connected liabilities under §1.882–5(c), A must determine the average total value of its assets that are U.S. assets. Assume that the average value of such assets is $100, while the amount of such assets as of the close of 1997 is $125. For purposes of §1.882–5(c)(2), A must determine the ratio of the average of its worldwide liabilities for the year to the average total value of worldwide assets for the taxable year. Assume that A's average liabilities-to-assets ratio under §1.882–5(c)(2) is 55 percent, while its liabilities-to-assets ratio at the close of 1997 is only 50 percent. Thus, assuming no further adjustments under paragraph (e)(3) of this section, A's U.S.-connected liabilities for purposes of §1.882–5 are $55 ($100 × 55%). However, A's U.S. liabilities are $62.50 for purposes of this section, the value of its assets determined under §1.882–5(b)(2) as of the close of December ($125) multiplied by the liabilities-to-assets ratio of (50%) as of such date.

Example 2. Election made to reduce liabilities. (i) As of the close of 2007, foreign corporation A, a real estate company, owns U.S. assets with an E&P basis of $1000. A has $800 of liabilities under paragraph (e)(1) of this section. A has accumulated ECEP of $500 and in 2008, A has $60 of ECEP that it intends to retain for future expansion of its U.S. trade or business. A elects under paragraph (e)(3) of this section to reduce its liabilities by $60 from $800 to $740. As a result of the election, assuming A's U.S. assets and U.S. liabilities would otherwise have remained constant, A's U.S. net equity as of the close of 2007 will increase by the amount of the decrease in liabilities ($60) from $200 to $260 and its ECEP will be reduced to zero. Under paragraph (e)(3)(iii) of this section, A's interest expense for the taxable year is reduced by the amount of interest attributable to $60 of liabilities and A's excess interest is reduced by the same amount. A's taxable income and ECEP are increased by the amount of the reduction in interest expense attributable to the liabilities, and A may make an election under paragraph (e)(3) of this section to further reduce its liabilities, thus increasing its U.S. net equity and reducing the amount of additional ECEP created for the election.

(ii) In 2009, assuming A again has $60 of ECEP, A may again make the election under paragraph (e)(3) to reduce its liabilities. However, assuming A's U.S. assets and liabilities under paragraph (e)(1) of this section remain constant, A will need to make an election to reduce its liabilities by $120 to reduce to zero its ECEP in 2009 and to continue to retain for expansion (without the payment of the branch profits tax) the $60 of ECEP earned in 2008. Without an election to reduce liabilities, A's dividend equivalent amount for 2009 would be $120 ($60 of ECEP plus the $60 reduction in U.S. net equity from $260 to $200). If A makes the election to reduce liabilities by $120 (from $800 to $680), A's U.S. net equity will increase by $60 (from $260 at the end of the previous year to $320), the amount necessary to reduce its ECEP to $0. However, the reduction of liabilities will itself create additional ECEP subject to section 884 because of the reduction in interest expense attributable to the $120 of liabilities. A can make the election to reduce liabilities by $120 without exceeding the limitation on the election provided in paragraph (e)(3)(ii) of this section because the $120 reduction does not exceed the amount needed to treat the 2009 and 2008 ECEP as reinvested in the net equity of the trade or business within the United States.

(iii) If A terminates its U.S. trade or business in 2009 in accordance with the rules in §1.884–2T(a), A would not be subject to the branch profits tax on the $60 of ECEP earned in that year. Under paragraph (e)(3)(v) of this section, however, it would be subject to the branch profits tax on the portion of the $60 of ECEP that it earned in 2008 that became accumulated ECEP because of an election to reduce liabilities.

(f) *Effectively connected earnings and profits*—(1) *In general*. Except as provided in paragraph (f)(2) of this section and as modified by §1.884–2T (relating to the incorporation or complete termination of a U.S. trade or business or the reorganization or liquidation of a foreign corporation or its domestic subsidiary), the term ''effectively connected earnings and profits'' (''ECEP'') means the earnings and profits (or deficits therein) determined under section 312 and this paragraph (f) that are attributable to ECI (within the meaning of paragraph (d)(1)(iii) of this section). Because the term ''ECI'' includes income treated as effectively connected, income that is ECI under section 842(b) (relating to minimum net investment income of an insurance business) or 864(c)(7) (relating to gain from property formerly held for use in a U.S. trade or

business) gives rise to ECEP. ECEP also includes earnings and profits attributable to ECI of a foreign corporation earned through a partnership, and through a trust or estate. For purposes of section 884, gain on the sale of a U.S. real property interest by a foreign corporation that has made an election to be treated as a domestic corporation under section 897(i) will also give rise to ECEP. ECEP is not reduced by distributions made by the foreign corporation during any taxable year or by the amount of branch profits tax or tax on excess interest (as defined in §1.884–4(a)(2)) paid by the foreign corporation. Earnings and profits are treated as attributable to ECI even if the earnings and profits are taken into account under section 312 in an earlier or later taxable year than the taxable year in which the ECI is taken into account.

(2) *Income that does not produce ECEP*. The term ''ECEP'' does not include any earnings and profits attributable to—

(i) Income excluded from gross income under section 883(a)(1) or 883(a)(2) (relating to certain income derived from the operation of ships or aircraft);

(ii) Income that is ECI by reason of section 921(d) or 926(b) (relating to certain income of a FSC and certain dividends paid by a FSC to a foreign corporation or nonresident alien) that is not otherwise ECI;

(iii) Gain on the disposition of a U.S. real property interest described in section 897(c)(1)(A)(ii) (relating to certain interests in a domestic corporation);

(iv) Income that is ECI by reason of section 953(c)(3)(C) (relating to certain income of a captive insurance company that a corporation elects to treat as ECI) that is not otherwise ECI;

(v) Income that is exempt from tax under section 892 (relating to certain income of foreign governments); and

(vi) Income that is ECI by reason of section 882(e) (relating to certain interest income of banks organized under the laws of a possession of the United States) that is not otherwise ECI.

(3) *Allocation of deductions attributable to income that does not produce ECEP*. In determining the amount of a foreign corporation's ECEP for the taxable year, deductions and other adjustments shall be allocated and apportioned under the principles of §1.861–8 between ECI that gives rise to ECEP and income described in paragraph (f)(2) of this section (relating to income that is ECI but does not give rise to ECEP).

(4) *Examples*. The principles of paragraph (f) of this section are illustrated by the following examples.

Example 1. Tax-exempt income. Foreign corporation A owns a tax-exempt municipal bond that is a U.S. asset as of the close of its 1989 taxable year. The municipal bond gives rise in 1989 to ECI (even though the income is excluded from gross income under section 103(a) and is not gross income of a foreign corporation by reason of section 882(b)), and therefore gives rise to ECEP in 1989.

Example 2. Income exempt under a treaty. Foreign corporation A derives ECI that constitutes business profits that are not attributable to a permanent establishment maintained by A in the United States. The ECI is exempt from taxation under section 882(a) by reason of an income tax treaty and section 894(a). The income nevertheless gives rise to ECEP under this paragraph (f). However, a dividend equivalent amount attributable to such ECEP may be exempt from the branch profits tax by reason of paragraph (g) of this section (relating to the application of the branch profits tax to corporations that are residents of countries with which the United States has an income tax treaty).

(g) *Corporations resident in countries with which the United States has an income tax treaty*—(1) *General rule*. Except as provided in paragraph (g)(2) of this section, a foreign corporation that is a resident of a country with which the United States has an income tax treaty in effect for a taxable year in which it has a dividend equivalent amount and that meets the requirements, if any, of the limitation on benefits provisions of such treaty with respect to the dividend equivalent amount shall not be subject to the branch profits tax on such amount (or will qualify for a reduction in the amount of tax with respect to such amount) only if—

(i) The foreign corporation is a qualified resident of such country for the taxable year, within the meaning of §1.884–5(a); or

(ii) The limitation on benefits provision, or an amendment to that provision, entered into force after December 31, 1986.

If, after application of §1.884–5(e)(4)(iv), a foreign corporation is a qualified resident under §1.884–5(e) (relating to the active trade or business test) only

with respect to one of its trades or businesses in the United States, i.e., the trade or business that is an integral part of its business conducted in its country of residence, and not with respect to another, the rules of this paragraph shall apply only to that portion of its dividend equivalent amount attributable to the trade or business for which the foreign corporation is a qualified resident.

(2) *Special rules for foreign corporations that are qualified residents on the basis of their ownership*—(i) *General rule.* A foreign corporation that, in any taxable year, is a qualified resident of a country with which the United States has an income tax treaty in effect solely by reason of meeting the requirements of §1.884–5 (b) and (c) (relating, respectively, to stock ownership and base erosion) shall be exempt from the branch profits tax or subject to a reduced rate of branch profits tax under paragraph (g)(1) of this section with respect to the portion of its dividend equivalent amount for the taxable year attributable to accumulated ECEP only if the foreign corporation is a qualified resident of such country within the meaning of §1.884–5(a) for the taxable years includable, in whole or in part, in a consecutive 36-month period that includes the taxable year of the dividend equivalent amount. A foreign corporation that fails the 36-month test described in the preceding sentence shall be exempt from the branch profits tax or subject to the branch profits tax at a reduced rate under paragraph (g)(1) of this section with respect to accumulated ECEP (determined on a last-in-first-out basis) accumulated only during prior years in which the foreign corporation was a qualified resident of such country within the meaning of §1.884–5(a).

(ii) *Rules of application.* A foreign corporation that has not satisfied the 36-month test as of the close of the taxable year of the dividend equivalent amount but satisfies the test with respect to such dividend equivalent amount by meeting the 36-month test by the close of the second taxable year succeeding the taxable year of the dividend equivalent amount shall be subject to the branch profits tax for the year of the dividend equivalent amount without regard to paragraph (g)(1) of this section on the portion of the dividend equivalent amount attributable to accumulated ECEP derived in a taxable year in which the foreign corporation was not a qualified resident within the meaning of §1.884–5(a). Upon meeting the 36-month test, the foreign corporation shall be entitled to claim by amended return a refund of the tax paid with respect to the dividend equivalent amount in excess of the branch profits tax calculated by taking into account paragraph (g)(2)(i) of this section, provided the foreign corporation establishes in the amended return for the taxable year that it has met the requirements of such paragraph. For purposes of section 6611 (dealing with interest on overpayments), any overpayment of branch profits tax by reason of this paragraph (g)(2)(ii) shall be deemed not to have been made before the filing date for the taxable year in which the foreign corporation establishes that it has met the 36-month test.

(iii) *Example.* The application of this paragraph (g)(2) is illustrated by the following example.

Example. (i) Foreign corporation A, a calendar year taxpayer, is a resident of the United Kingdom. A has a dividend equivalent amount for its taxable year 1991 of $300, of which $100 is attributable to 1991 ECEP and $200 to accumulated ECEP. A is a qualified resident for its taxable year 1991 because for that year it meets the requirements of §1.884–5 (b) and (c), relating, respectively, to stock ownership and base erosion. For 1991 A does not meet the requirements of §1.884–5 (d), (e), or (f) for qualified residence. A is not a qualified resident of the United Kingdom for any taxable year prior to 1990 but is a qualified resident for its taxable years 1990 and 1992.

(ii) Because A is a qualified resident for the 3-year period (1990, 1991, and 1992) that includes the taxable year of the dividend equivalent amount (1991), A satisfies the 36-month test of this paragraph (g)(2) and no branch profits tax is imposed on the total $300 dividend equivalent amount. However, since A was not a qualified resident for any taxable year prior to 1990 and therefore cannot establish that it has satisfied the 36-month test until the taxable year following the year of the dividend equivalent amount, A must pay the branch profits tax for its taxable year 1991 with respect to the portion of the dividend equivalent amount attributable to accumulated ECEP relating to years prior

to 1990 without regard to paragraph (g)(1) of this section. A may file for a refund of the branch profits tax paid with respect to its 1991 taxable year at any time after it establishes that it is a qualified resident for its 1992 taxable year.

(3) *Exemptions for foreign corporations resident in certain countries with income tax treaties in effect on January 1, 1987.* The branch profits tax shall not be imposed on the portion of the dividend equivalent amount with respect to which a foreign corporation satisfies the requirements of paragraphs (g) (1) and (2) of this section for a country listed below, so long as the income tax treaty between the United States and that country, as in effect on January 1, 1987, remains in effect, except to the extent the treaty is modified on or after January 1, 1987, to expressly provide for the imposition of the branch profits tax:

Aruba
Austria
Belgium
People's Republic of China
Cyprus
Denmark
Egypt
Finland
Germany
Greece
Hungary
Iceland
Ireland
Italy
Jamaica
Japan
Korea
Luxembourg
Malta
Morocco
Netherlands
Netherlands Antilles
Norway
Pakistan
Philippines
Sweden
Switzerland
United Kingdom

(4) *Modifications with respect to other income tax treaties*—(i) *Limitation on rate of tax*—(A) *General rule.* If, under paragraphs (g) (1) and (2) of this section, a corporation qualifies for a reduction in the amount of the branch profits tax and paragraph (g)(3) of this section does not apply, the rate of tax shall be the rate of tax on branch profits specified in the treaty between the United States and the corporation's country of residence or, if no rate of tax on branch profits is specified, the rate of tax that would apply under such treaty to dividends paid to the foreign corporation by a wholly-owned domestic corporation.

(B) *Certain treaties in effect on January 1, 1987.* The branch profits tax shall generally be imposed at the following rates on the portion of the dividend equivalent amount with respect to which a foreign corporation satisfies the requirements of paragraphs (g) (1) and (2) of this section for a country listed below, for as long as the relevant provisions of those income tax treaties remain in effect and are not modified or superseded by subsequent agreement:

Australia (15%)
Barbados (5%)
Canada (10%)
France (5%)
New Zealand (5%)
Poland (5%)
Romania (10%)
South Africa (30%)
Trinidad & Tobago (10%)
U.S.S.R. (30%)

However, for special rates imposed on corporations resident in France and Trinidad & Tobago that have certain amounts of dividend and interest income, see the dividend articles of the income tax treaties with those countries.

(ii) *Limitations other than rate of tax.* If, under paragraphs (g) (1) and (2) of this section, a foreign corporation qualifies for a reduction in the amount of branch profits tax and paragraph (g) (3) of this section does not apply, then—

(A) The foreign corporation shall be entitled to the benefit of any limitations on imposition of a tax on branch profits (in addition to any limitations on the rate of tax) contained in the treaty; and

(B) No branch profits tax shall be imposed with respect to a dividend equivalent amount out of ECEP or accumulated ECEP of the foreign corporation unless the ECEP or accumulated ECEP is attributable to a permanent establishment in the United States or, if not otherwise prohibited under the treaty, to gain from the disposition of a U.S. real property interest described in section 897(c)(1)(A)(i), except to the extent the treaty specifically permits the imposition of the branch profits tax on such earnings and profits.

No article in such treaty shall be construed to provide any limitations on imposition of the branch profits tax other than as provided in this paragraph (g)(4).

(iii) *Computation of the dividend equivalent amount if a foreign corporation has both ECEP attributable to a permanent establishment and not attributable to a permanent establishment.* To determine the dividend equivalent amount of a

foreign corporation out of ECEP that is attributable to a permanent establishment, the foreign corporation may only take into account its U.S. assets, U.S. liabilities, U.S. net equity and ECEP attributable to its permanent establishment. Thus, a foreign corporation may not reduce the amount of its ECEP attributable to its permanent establishment by reinvesting all or a portion of that amount in U.S. assets not attributable to the permanent establishment.

(iv) *Limitations under the Canadian treaty*. The limitations on the imposition of the branch profits tax under the Canadian treaty include, but are not limited to, those described in paragraphs (g)(4)(iv) (A) and (B).

(A) *Effect of deficits in earnings and profits*. In the case of a foreign corporation that is a qualified resident of Canada, the dividend equivalent amount for any taxable year shall not exceed the foreign corporation's accumulated ECEP as of the beginning of the taxable year plus the corporation's ECEP for the taxable year. Thus, for example, if a foreign corporation that is a qualified resident of Canada has a deficit in accumulated ECEP of $200 as of the beginning of the taxable year and ECEP of $100 for the taxable year, it will have no dividend equivalent amount for the taxable year because it would have a cumulative deficit in ECEP of $100 as of the close of the taxable year. For purposes of this paragraph (g)(4)(iii)(A), any net deficit in accumulated earnings and profits attributable to taxable years beginning before January 1, 1987, shall be includible in determining accumulated ECEP.

(B) *One-time exemption of Canadian $500,000—(1) General rule*. In the case of a foreign corporation that is a qualified resident of Canada, the branch profits tax shall be imposed only with respect to that portion of the dividend equivalent amount for the taxable year that, when translated into Canadian dollars and added to the dividend equivalent amounts for preceding taxable years translated into Canadian dollars, exceeds Canadian $500,000. The value of the dividend equivalent amount in Canadian currency shall be determined by translating the ECEP for each taxable year that is includible in the dividend equivalent amount (as determined in U.S. dollars under the currency translation method used in determining the foreign corporation's taxable income for U.S. tax purposes) by the weighted average exchange rate for the taxable year (determined under the rules of section 989(b)(3)) during which the earnings and profits were derived.

(*2*) *Reduction in amount of exemption in the case of related corporations*. The amount of a foreign corporation's exemption under this paragraph (g)(4)(iii)(B) shall be reduced by the amount of any exemption that reduced the dividend equivalent amount of an associated foreign corporation with respect to the same or a similar business. For purposes of this paragraph (g)(4)(iii)(B), a foreign corporation is an associated foreign corporation if it is related to the foreign corporation for purposes of sectional 267(b) or it and the foreign corporation are stapled entities (within the meaning of section 269B(c)(2)) or are effectively stapled entities. A business is the same as or similar to another business if it involves the sale, lease, or manufacture of the same or a similar type of property or the provision of the same or a similar type of services. A U.S. real property interest described in section 897(c)(1)(A)(i) shall be treated as a business and all such U.S. real property interests shall be treated as businesses that are the same or similar.

(*3*) *Coordination with second-tier withholding tax*. The value of the dividend equivalent amount that is exempt from the branch profits tax by reason of paragraph (g)(4)(iii)(B)(*1*) of this section shall not be subject to tax under section 871(a) or 881, or to withholding under section 1441 or 1442, when distributed by the foreign corporation.

(5) *Benefits under treaties other than income tax treaties*. A treaty that is not an income tax treaty does not exempt a foreign corporation from the branch profits tax or reduce the amount of the tax.

(h) *Stapled entities*. Any foreign corporation that is treated as a domestic corporation by reason of section 269B (relating to stapled entities) shall continue to be treated as a foreign corporation for purposes of section 884 and

the regulations thereunder, notwithstanding section 269B or the regulations thereunder. Dividends paid by such foreign corporation shall be treated as paid by a domestic corporation and shall be subject to the tax imposed by section 871(a) or 881(a), and to withholding under section 1441 or 1442, as applicable, to the extent paid out of earnings and profits that are not subject to tax under section 884(a). Dividends paid by such foreign corporation out of earnings and profits subject to tax under section 884(a) shall be exempt from the tax imposed by sections 871(a) and 881(a) and shall not be subject to withholding under section 1441 or 1442. Whether dividends are paid out of earnings and profits that are subject to tax under section 884(a) shall be determined under section 884(e)(3)(A) and the regulations thereunder. The limitation on the application of treaty benefits in section 884(e)(3)(B) (relating to qualified residents) shall apply to a foreign corporation described in this paragraph (h).

(i) *Effective date*—(1) *General rule.* This section is effective for taxable years beginning on or after October 13, 1992. With respect to a taxable year beginning before October 13, 1992 and after December 31, 1986, a foreign corporation may elect to apply this section in lieu of §1.884–1T of the temporary regulations (as contained in the CFR edition revised as of April 1, 1992), but only if the foreign corporation also makes an election under §1.884–4 (e) to apply §1.884.4 in lieu of §1.884–4T (as contained in the CFR edition revised as of April 1, 1992) for that taxable year, and the statute of limitations for assessment of a deficiency has not expired for that taxable year. Once an election has been made, an election under this section shall apply to all subsequent taxable years. However, paragraph (f)(2)(vi) of this section (relating to certain interest income of Possessions banks) shall not apply for taxable years beginning before January 1, 1990.

(2) *Election to reduce liabilities.* A foreign corporation may make an election to reduce its liabilities under paragraph (e)(3) of this section with respect to a taxable year for which an election under paragraph (i)(1) of this section is in effect by filing an amended return for the taxable year and recomputing its interest deduction and any other item affected by the election on an amended Form 1120F to take into account the reduction in liabilities for such year.

(3) *Separate election for installment obligations.* A foreign corporation may make a separate election to apply paragraphs (d)(2)(iii) and (d)(6)(ii) of this section (relating to installment obligations treated as U.S. assets) to any prior taxable year without making an election under paragraph (i)(1) of this section, provided the statute of limitations for assessment of a deficiency has not expired for that taxable year and each succeeding taxable year. Once an election under this paragraph (i)(3) has been made, it shall apply to all subsequent taxable years.

(4) *Special rules for certain U.S. assets and liabilities.* Paragraphs (c)(2) (i) and (ii), (d)(3), (d)(4), (d)(5)(iii), (d)(6)(iii), (d)(6)(vi), (e)(2), and (e)(3)(ii), of this section are effective for taxable years beginning on or after June 6, 1996.

(j) *Transition rules*—(1) *General rule.* Except as provided in paragraph (j)(2) of this section, in order to compute its dividend equivalent amount in the first taxable year to which this section applies (whether or not such year begins before October 13, 1992, a foreign corporation must recompute its U.S. net equity as of close of the preceding taxable year using the rules of this section and use such recomputed amount, rather than the amount computed under §1.884–1T (as contained in the CFR edition revised as of April 1, 1992), to determine the amount of any increase or decrease in the U.S. net equity as of the close of that taxable year.

(2) *Installment obligations*—(i) *Interest election.* In recomputing its U.S. net equity as of the close of the preceding taxable year, a foreign corporation that holds an installment obligation treated as a U.S. asset under §1.884–1T(d)(7) (as contained in the CFR edition revised as of April 1, 1992) as of such date may apply the rules of paragraph (d)(2)(iii) of this section without regard to the rule in that paragraph that requires interest or original issue

discount on the obligation to be treated as ECI in order for such obligation to be treated as a U.S. asset.

(ii) *1987 sales by certain foreign corporations.* The E&P basis of an installment obligation arising in connection with a sale of property by a foreign corporation described in section 312(k)(4), where such sale occurs in a taxable year beginning in 1987, shall equal the E&P basis of the property sold as of the determination date reduced by payments received with respect to the obligation that do not represent gain for earnings and profits purposes, interest or original issue discount.

[T.D. 8432, 57 FR 41651, Sept. 11, 1992; 57 FR 49117, Oct. 29, 1992; 57 FR 60126, Dec. 18, 1992; 58 FR 17166, Apr. 1, 1993, as amended by T.D. 8657, 61 FR 9338, Mar. 8, 1996; 61 FR 14247, Apr. 1, 1996; T.D. 9281, 71 FR 47451, Aug. 17, 2006; T.D. 9465, 74 FR 49320, Sept. 28, 2009; 74 FR 57252, Nov. 5, 2009]

§ 1.884–2 Special rules for termination or incorporation of a U.S. trade or business or liquidation or reorganization of a foreign corporation or its domestic subsidiary.

(a) through (a)(2)(i) [Reserved]. For further information, see § 1.884–2T(a) through (a)(2)(ii).

(a)(2)(ii) *Waiver of period of limitations.* The waiver referred to in § 1.884–2T(a)(2)(i)(D) shall be executed on Form 8848, or substitute form, and shall extend the period for assessment of the branch profits tax for the year of complete termination to a date not earlier than the close of the sixth taxable year following that taxable year. This form shall include such information as is required by the form and accompanying instructions. The waiver must be signed by the person authorized to sign the income tax returns for the foreign corporation (including an agent authorized to do so under a general or specific power of attorney). The waiver must be filed on or before the date (including extensions) prescribed for filing the foreign corporation's income tax return for the year of complete termination. With respect to a complete termination occurring in a taxable year ending prior to June 6, 1996 a foreign corporation may also satisfy the requirements of this paragraph (a)(2)(ii) by applying § 1.884–2T(a)(2)(ii) of the temporary regulations (as contained in the CFR edition revised as of April 1, 1995). A properly executed Form 8848, substitute form, or other form of waiver authorized by this paragraph (a)(2)(ii) shall be deemed to be consented to and signed by a Service Center Director or the Assistant Commissioner (International) for purposes of § 301.6501(c)–1(d) of this chapter.

(a)(3) through (a)(4) [Reserved]. For further information, see § 1.884–2T(a)(3) through (a)(4).

(a)(5) *Special rule if a foreign corporation terminates an interest in a trust.* A foreign corporation whose beneficial interest in a trust terminates (by disposition or otherwise) in any taxable year shall be subject to the branch profits tax on ECEP attributable to amounts (including distributions of accumulated income or gain) treated as ECI to such beneficiary in such taxable year notwithstanding any other provision of § 1.884–2T(a).

(b) through (c)(2)(ii) [Reserved]. For further information, see § 1.884–2T (b) through (c)(2)(ii).

(c)(2)(iii) *Waiver of period of limitations and transferee agreement.* In the case of a transferee that is a domestic corporation, the provisions of § 1.884–2T(c)(2)(i) shall not apply unless, as part of the section 381(a) transaction, the transferee executes a Form 2045 (Transferee Agreement) and a waiver of period of limitations as described in this paragraph (c)(2)(iii), and files both documents with its timely filed (including extensions) income tax return for the taxable year in which the section 381(a) transaction occurs. The waiver shall be executed on Form 8848, or substitute form, and shall extend the period for assessment of any additional branch profits tax for the taxable year in which the section 381(a) transaction occurs to a date not earlier than the close of the sixth taxable year following the taxable year in which such transaction occurs. This form shall include such information as is required by the form and accompanying instructions. The waiver must be signed by the person authorized to sign Form

2045. With respect to a complete termination occurring in a taxable year ending prior to June 6, 1996 a foreign corporation may also satisfy the requirements of this paragraph (c)(2)(iii) by applying §1.884–2T(c)(2)(iii) of the temporary regulations (as contained in the CFR edition revised as of April 1, 1995). A properly executed Form 8848, substitute form, or other form of waiver authorized by this paragraph (c)(2)(iii) shall be deemed to be consented to and signed by a Service Center Director or the Assistant Commissioner (International) for purposes of §301.6501(c)–1(d) of this chapter.

(c)(3) through (c)(6)(i)(A) [Reserved]. For further guidance, see §1.884–2T(c)(3) through (c)(6)(i)(A).

(B) Shareholders of the transferee (or of the transferee's parent in the case of a triangular reorganization described in section 368(a)(1)(C) or a reorganization described in sections 368(a)(1)(A) and 368(a)(2)(D) or (E)) who in the aggregate owned more than 25 percent of the value of the stock of the transferor at any time within the 12-month period preceding the close of the year in which the section 381(a) transaction occurs sell, exchange or otherwise dispose of their stock or securities in the transferee at any time during a period of three years from the close of the taxable year in which the section 381(a) transaction occurs.

(C) In the case of a triangular reorganization described in section 368(a)(1)(C) or a reorganization described in sections 368(a)(1)(A) and 368(a)(2)(D) or (E), the transferee's parent sells, exchanges, or otherwise disposes of its stock or securities in the transferee at any time during a period of three years from the close of the taxable year in which the section 381(a) transaction occurs.

(D) A corporation related to any such shareholder or the shareholder itself if it is a corporation (subsequent to an event described in paragraph (c)(6)(i)(A) or (B) of this section) or the transferee's parent (subsequent to an event described in paragraph (c)(6)(i)(C) of this section), uses, directly or indirectly, the proceeds or property received in such sale, exchange or disposition, or property attributable thereto, in the conduct of a trade or business in the United States at any time during a period of three years from the date of sale in the case of a disposition of stock in the transferor, or from the close of the taxable year in which the section 381(a) transaction occurs in the case of a disposition of the stock or securities in the transferee (or the transferee's parent in the case of a triangular reorganization described in section 368(a)(1)(C) or a reorganization described in sections 368(a)(1)(A) and (a)(2)(D) or (E)). Where this paragraph (c)(6)(i) applies, the transferor's branch profits tax liability for the taxable year in which the section 381(a) transaction occurs shall be determined under §1.884–1, taking into account all the adjustments in U.S. net equity that result from the transfer of U.S. assets and liabilities to the transferee pursuant to the section 381(a) transaction, without regard to any provisions in this paragraph (c). If an event described in paragraph (c)(6)(i)(A), (B), or (C) of this section occurs after the close of the taxable year in which the section 381(a) transaction occurs, and if additional branch profits tax is required to be paid by reason of the application of this paragraph (c)(6)(i), then interest must be paid on that amount at the underpayment rates determined under section 6621(a)(2), with respect to the period between the date that was prescribed for filing the transferor's income tax return for the year in which the section 381(a) transaction occurs and the date on which the additional tax for that year is paid. Any such additional tax liability together with interest thereon shall be the liability of the transferee within the meaning of section 6901 pursuant to section 6901 and the regulations thereunder.

(c)(6)(ii) through (f) [Reserved]. For further guidance, see §1.884–2T(c)(6)(ii) through (f).

(g) *Effective dates.* Paragraphs (a)(2)(ii) and (c)(2)(iii) of this section are effective for taxable years beginning after December 31, 1986. Paragraph (a)(5) of this section is effective for taxable years beginning on or after June 6, 1996. Paragraphs (c)(6)(i)(B), (C), and (D), are applicable for tax years beginning after December 31, 1986, except that such paragraphs are applicable to

transactions occurring on or after January 23, 2006, in the case of reorganizations described in sections 368(a)(1)(A) and 368(a)(2)(D) or (E).

[T.D. 8657, 61 FR 9341, Mar. 8, 1996, as amended by T.D. 9243, 71 FR 4292, Jan. 26, 2006]

§ 1.884–2T Special rules for termination or incorporation of a U.S. trade or business or liquidation or reorganization of a foreign corporation or its domestic subsidiary (temporary).

(a) *Complete termination of a U.S. trade or business*—(1) *General rule.* A foreign corporation shall not be subject to the branch profits tax for the taxable year in which it completely terminates all of its U.S. trade or business within the meaning of paragraph (a)(2) of this section. A foreign corporation's non-previously taxed accumulated effectively connected earnings and profits as of the close of the taxable year of complete termination shall be extinguished for purposes of section 884 and the regulations thereunder, but not for other purposes (for example, sections 312, 316 and 381).

(2) *Operating rules*—(i) *Definition of complete termination.* A foreign corporation shall have completely terminated all of its U.S. trade or business for any taxable year (''the year of complete termination'') only if—

(A) As of the close of that taxable year, the foreign corporation either has no U.S. assets, or its shareholders have adopted an irrevocable resolution in that taxable year to completely liquidate and dissolve the corporation and, before the close of the immediately succeeding taxable year (also a ''year of complete termination'' for purposes of applying this paragraph (a)(2)), all of its U.S. assets are either distributed, used to pay off liabilities, or cease to be U.S. assets;

(B) Neither the foreign corporation nor a related corporation uses, directly or indirectly, any of the U.S. assets of the terminated U.S. trade or business, or property attributable thereto or to effectively connected earnings and profits earned by the foreign corporation in the year of complete termination, in the conduct of a trade or business in the United States at any time during a period of three years from the close of the year of complete termination;

(C) The foreign corporation has no income that is, or is treated as, effectively connected with the conduct of a trade or business in the United States (other than solely by reason of section 864 (c)(6) or (c)(7)) during the period of three years from the close of the year of complete termination; and

(D) The foreign corporation attaches to its income tax return for each year of complete termination a waiver of the period of limitations, as described in paragraph (a)(2)(ii) of this section.

If a foreign corporation fails to completely terminate all of its U.S. trade or business because of the failure to meet any of the requirements of this paragraph (a)(2), then its branch profits tax liability for the taxable year and all subsequent taxable years shall be determined under the provisions of § 1.884–1, without regard to any provisions in this paragraph (a), taking into account any reduction in U.S. net equity that results from a U.S. trade or business of the foreign corporation ceasing to have U.S. assets. Any additional branch profits tax liability that may result, together with interest thereon (charged at the underpayment rates determined under section 6621(a)(2) with respect to the period between the date that was prescribed for filing the foreign corporation's income tax return for the taxable year with respect to which the branch profits tax liability arises and the date on which the additional tax for that year is paid), and applicable penalties, if any, shall be the liability of the foreign corporation (or of any person who is a transferee of the foreign corporation within the meaning of section 6901).

(ii) *Waiver of period of limitations.* [Reserved]. See § 1.884–2(a)(2)(ii) for rules relating to this paragraph.

(iii) *Property subject to reinvestment prohibition rule.* For purposes of paragraph (a)(2)(i)(B) of this section—

(A) The term *U.S. assets of the terminated U.S. trade or business* shall mean all the money and other property that qualified as U.S. assets of the foreign corporation as of the close of the taxable year immediately preceding the year of complete termination; and

(B) Property attributable to U.S. assets or to effectively connected earnings and profits earned by the foreign corporation in the year of complete termination shall mean money or other property into which any part or all of such assets or effectively connected earnings and profits are converted at any time before the expiration of the three-year period specified in paragraph (a)(2)(i)(B) of this section by way of sale, exchange, or other disposition, as well as any money or other property attributable to the sale by a shareholder of the foreign corporation of its interest in the foreign corporation (or a successor corporation) at any time after a date which is 12 months before the close of the year of complete termination (24 months in the case of a foreign corporation that makes an election under paragraph (b) of this section).

(iv) *Related corporation.* For purposes of paragraph (a)(2)(i)(B) of this section, a corporation shall be related to a foreign corporation if either corporation is a 10-percent shareholder of the other corporation or, where the foreign corporation completely liquidates, if either corporation would have been a 10-percent shareholder of the other corporation had the foreign corporation remained in existence. For this purpose, the term *10-percent shareholder* means any person described in section 871(h)(3)(B) as well as any person who owns 10 percent or more of the total value of the stock of the corporation, and stock ownership shall be determined on the basis of the attribution rules described in section 871(h)(3)(C).

(v) *Direct or indirect use of U.S. assets.* The use of any part or all of the property referred to in paragraph (a)(2)(i)(B) of this section shall include the loan thereof to a related corporation or the use thereof as security (as a pledge, mortgage, or otherwise) for any indebtedness of a related corporation.

(3) *Complete termination in the case of a section 338 election.* A foreign corporation whose stock is acquired by another corporation that makes (or is deemed to make) an election under section 338 with respect to the stock of the foreign corporation shall be treated as having completely liquidated as of the close of the acquisition date (as defined in section 338(h)(2)) and to have completely terminated all of its U.S. trade or business with respect to the taxable year ending on such acquisition date provided the foreign corporation that exists prior to the section 338 transaction complies with the requirements of paragraph (a)(2)(i) (B) and (D) of this section. For purposes of the preceding sentence, any of the money or other property paid as consideration for the acquisition of the stock in the foreign corporation (and for any debt claim against the foreign corporation) shall be treated as property attributable to the U.S. assets of the terminated U.S. trade or business and to the effectively connected earnings and profits of the foreign corporation earned in the year of complete termination.

(4) *Complete termination in the case of a foreign corporation with income under section 864(c)(6) or 864(c)(7).* No branch profits tax shall be imposed on effectively connected earnings and profits attributable to income that is treated as effectively connected with the conduct of a trade or business in the United States solely by reason of section 864(c)(6) or 864(c)(7) if—

(i) No income of the foreign corporation for the taxable year is, or is treated as, effectively connected with the conduct of a trade or business in the United States, without regard to section 864(c)(6) or 864(c)(7),

(ii) The foreign corporation has no U.S. assets as of the close of the taxable year, and

(iii) Such effectively connected earnings and profits would not have been subject to branch profits tax pursuant to the complete termination provisions of paragraph (a)(1) of this section if income or gain subject to section 864(c)(6) had not been deferred or if property subject to section 864(c)(7) had been sold immediately prior to the date the property ceased to have been used in the conduct of a trade or business in the United States.

(5) *Special rule if a foreign corporation terminates an interest in a trust.* [Reserved]. See §1.884–2(a)(5) for rules relating to this paragraph.

(6) *Coordination with second-level withholding tax*. Effectively connected earnings and profits and non-previously taxed accumulated effectively connected earnings and profits of a foreign corporation that are exempt from branch profits tax by reason of the provisions of paragraph (a)(1) of this section shall not be subject to tax under section 871(a), 881(a), 1441 or 1442 when paid as a dividend by such foreign corporation (or a successor-in-interest).

(b) *Election to remain engaged in a U.S. trade or business*—(1) *General rule*. A foreign corporation that would be considered to have completely terminated all of its U.S. trade or business for the taxable year under the provisions of paragraph (a)(2)(i) of this section, but for the provisions of paragraph (a)(2)(i)(B) of this section that prohibit reinvestment within a three-year period, may make an election under this paragraph (b) for the taxable year in which it completely terminates all its U.S. trade or business (as determined without regard to paragraph (a)(2)(i)(B) of this section) and, if it so chooses, for the following taxable year (but not for any succeeding taxable year). The election under this paragraph (b) is an election by the foreign corporation to designate an amount of marketable securities as U.S. assets for purposes of §1.884–1. The marketable securities identified pursuant to the election under paragraph (b)(3) of this section shall be treated as being U.S. assets in an amount equal, in the aggregate, to the lesser of the adjusted basis of the U.S. assets that ceased to be U.S. assets during the taxable year in which the election is made (determined on the date or dates the U.S. assets ceased to be U.S. assets) or the adjusted basis of the marketable securities as of the end of the taxable year. The securities must be held from the date that they are identified until the end of the taxable year for which the election is made, or if disposed of during the taxable year, must be replaced on the date of disposition with other marketable securities that are acquired on or before that date and that have a fair market value as of the date of substitution not less than their adjusted basis.

(2) *Marketable security*. For purposes of this paragraph (b), the term *marketable security* means a security (including stock) that is part of an issue any portion of which is regularly traded on an established securities market (within the meaning of §1.884–5(d)(2) and (4)) and a deposit described in section 871(i)(3) (A) or (B).

(3) *Identification requirements*. In order to qualify for this election—

(i) The marketable securities must be identified on the books and records of the U.S. trade or business within 30 days of the date an equivalent amount of U.S. assets ceases to be U.S. assets; and

(ii) On the date a marketable security is identified, its adjusted basis must not exceed its fair market value.

(4) *Treatment of income from deemed U.S. assets*. The income or gain from the marketable securities (or replacement securities) subject to an election under this paragraph (b) that arises in a taxable year for which an election is made shall be treated as ECI (other than for purposes of section 864(c)(7)), and losses from the disposition of such marketable securities shall be allocated entirely to income that is ECI. In addition, all such securities shall be treated as if they had been sold for their fair market value on the earlier of the last business day of a taxable year for which an election is in effect or the day immediately prior to the date of substitution by the foreign corporation of a U.S. asset for the marketable security, and any gain (but not loss) and accrued interest on the securities shall also be treated as ECI. The adjusted basis of such property shall be increased by the amount of any gain recognized by reason of this paragraph (b).

(5) *Method of election*. A foreign corporation may make an election under this paragraph (b) by attaching to its income tax return for the taxable year a statement—

(i) Identifying the marketable securities treated as U.S. assets under this paragraph (b);

(ii) Setting forth the E&P bases of such securities; and

(iii) Agreeing to treat any income, gain or loss as provided in paragraph (b)(4) of this section.

Such statement must be filed on or before the due date (including extensions)

of the foreign corporation's income tax return for the taxable year. A foreign corporation shall not be permitted to make an election under this paragraph (b) more than once.

(6) *Effective date*. This paragraph (b) is effective for taxable years beginning on or after October 13, 1992. However, if a foreign corporation has made a valid election under §1.884–1(i) to apply that section with respect to a taxable year beginning before October 13, 1992 and after December 31 1986, this paragraph (b) shall be effective beginning with such taxable year.

(c) *Liquidation, reorganization, etc. of a foreign corporation*. The following rules apply to the transfer by a foreign corporation engaged (or deemed engaged) in the conduct of a U.S. trade or business (the ''transferor'') of its U.S. assets to another corporation (the ''transferee'') in a complete liquidation or reorganization described in section 381(a) (a ''section 381(a) transaction'') if the transferor is engaged (or deemed engaged) in the conduct of a U.S. trade or business immediately prior to the section 381(a) transaction. For purposes of this paragraph (c), a section 381(a) transaction is considered to occur in the taxable year that ends on the date of distribution or transfer (as defined in §1.381(b)–1(b)) pursuant to the section 381(a) transaction.

(1) *Inapplicability of paragraph (a)(1) of this section to section 381(a) transactions*. Paragraph (a)(1) of this section (relating to the complete termination of a U.S. trade or business of a foreign corporation) does not apply to exempt the transferor from branch profits tax liability for the taxable year in which the section 381(a) transaction occurs or in any succeeding taxable year.

(2) *Transferor's dividend equivalent amount for the taxable year in which a section 381(a) transaction occurs*. The dividend equivalent amount for the taxable year, including a short taxable year, in which a section 381(a) transaction occurs shall be determined under the provisions of §1.884–1, as modified under the provisions of this paragraph (c)(2).

(i) *U.S. net equity*. The transferor's U.S. net equity as of the close of the taxable year shall be determined without regard to any transfer in that taxable year of U.S. assets to or from the transferee pursuant to a section 381(a) transaction, and without regard to any U.S. liabilities assumed or acquired by the transferee from the transferor in that taxable year pursuant to a section 381(a) transaction. The transferor's adjusted basis (for earnings and profits purposes) in U.S. assets transferred to the transferee pursuant to a section 381(a) transaction shall be the adjusted basis of those assets (for earnings and profits purposes) immediately prior to the section 381(a) transaction, adjusted as provided under section 362(b), treating the transferor, for that purpose, as though it were the transferee and treating the gain taken into account for earnings and profits purposes as gain recognized.

(ii) *Effectively connected earnings and profits*. The transferor's effectively connected earnings and profits for the taxable year in which the section 381(a) transaction occurs and its non-previously taxed accumulated effectively connected earnings and profits shall be determined without regard to the carryover to the transferee of the transferor's earnings and profits under section 381 (a) and (c)(2) and paragraph (c)(4) of this section. Effectively connected earnings and profits for the taxable year in which a section 381(a) transaction occurs shall be adjusted by the amount of any gain recognized to the transferor in that year pursuant to the section 381(a) transaction (to the extent taken into account for earnings and profits purposes).

(iii) *Waiver of period of limitations and transferee agreement*. [Reserved]. See §1.884–2(c)(2)(iii) for rules relating to this paragraph.

(3) *Transferor's dividend equivalent amount for any taxable year succeeding the taxable year in which the section 381(a) transaction occurs*. Any decrease in U.S. net equity in any taxable year succeeding the taxable year in which the section 381(a) transaction occurs shall increase the transferor's dividend equivalent amount for those years without regard to the limitation in §1.884–1(b)(3)(ii), to the extent such decrease in U.S. net equity does not exceed the balance of effectively connected earnings and profits and non-

previously taxed accumulated effectively connected earnings and profits carried over to the transferee pursuant to section 381 (a) and (c)(2), as determined under paragraph (c)(4) of this section.

(4) *Earnings and profits of the transferor carried over to the transferee pursuant to the section 381(a) transaction*—(i) *Amount*. The amount of effectively connected earnings and profits and non-previously taxed accumulated effectively connected earnings and profits of the transferor that carry over to the transferee under section 381 (a) and (c)(2) shall be the effectively connected earnings and profits and the non-previously taxed accumulated effectively connected earnings and profits of the transferor immediately before the close of the taxable year in which the section 381(a) transaction occurs. For this purpose, the provisions in § 1.381(c)(2)–1 shall generally apply with proper adjustments to reflect the fact that effectively connected earnings and profits and non-previously taxed accumulated effectively connected earnings and profits are not affected by distributions to shareholders but, rather, by dividend equivalent amounts. Therefore, the amounts of effectively connected earnings and profits and non-previously taxed accumulated effectively connected earnings and profits that carry over to the transferee pursuant to those provisions are reduced by the transferor's dividend equivalent amount for the taxable year in which the section 381(a) transaction occurs. Such amounts are also reduced to the extent of any dividend equivalent amount determined for any succeeding taxable year solely as a result of the provisions of paragraph (c)(3) of this section. For purposes of this paragraph (c)(4)(i), if the transferor accumulates non-previously taxed effectively connected earnings and profits, or incurs a deficit in effectively connected earnings and profits, attributable to a period that is after the close of the taxable year in which the section 381(a) transaction occurs and before the liquidation of the transferor, then such effectively connected earnings and profits, or deficits therein, shall be deemed to have been accumulated or incurred on or before the close of the taxable year in which the section 381(a) transaction occurs.

(ii) *Retention of character*. All of the transferor's effectively connected earnings and profits and non-previously taxed accumulated effectively connected earnings and profits that carry over to the transferee shall constitute non-previously taxed accumulated effectively connected earnings and profits of the transferee. In the case of a domestic transferee, such non-previously taxed accumulated effectively connected earnings and profits shall also constitute accumulated earnings and profits of the transferee for purposes of section 316(a)(2).

(iii) *Treatment of distributions by a domestic transferee out of non-previously taxed accumulated effectively connected earnings and profits*. In the event the transferee is a domestic corporation, distributions out of the transferee's non-previously taxed accumulated effectively connected earnings and profits that are received by a foreign distributee shall qualify for benefits under an applicable income tax treaty only (A) if the distributee qualifies for the benefits under such treaty and (B) to the extent that the transferor foreign corporation would have qualified under the principles of § 1.884–1(g) (1) and (2)(i) for an exemption or reduction in rate with respect to the branch profits tax if the non-previously taxed accumulated effectively connected earnings and profits had been reflected in a dividend equivalent amount for the taxable year in which the section 381(a) transaction occurs. (The tax rate on dividends specified in the treaty between the distributee's country of residence and the United States shall apply to any dividends received by a distributee who qualifies for a treaty benefit under the preceding sentence.) In addition, distributions out of such non-previously taxed accumulated effectively connected earnings and profits shall retain their character in the hands of any domestic distributee up a chain of corporate shareholders for purposes of applying this paragraph (c)(4)(iii) to distributions made by any such person to a foreign distributee. If a domestic transferee has non-previously taxed accumulated effectively connected earnings and profits carried over from the

transferor as well as accumulated earnings and profits, then each category of earnings and profits shall be accounted for in two separate pools, and any distribution of earnings and profits shall be treated as a distribution out of each pool in proportion to the respective amount of undistributed earnings and profits in each pool. Section 871(i) (relating, in part, to dividends paid by a domestic corporation meeting the 80-percent foreign business requirements of section 861(c)(1)) shall not apply to any dividends paid by a domestic transferee out of its non-previously taxed accumulated effectively connected earnings and profits.

(5) *Determination of U.S. net equity of a transferee that is a foreign corporation.* In the event the transferee is a foreign corporation, then for purposes of determining the transferee's increase or decrease in U.S. net equity under §1.884–1 for its taxable year during which the section 381(a) transaction occurs, its U.S. net equity as of the close of its immediately preceding taxable year shall be increased by the amount of U.S. net equity acquired by the transferee from the transferor pursuant to the section 381(a) transaction, taking into account the adjustments to the basis (for earnings and profits purposes) of U.S. assets under the principles of section 362(b).

(6) *Special rules in the case of the disposition of stock or securities in a domestic transferee or in the transferor*—(i) *General rule.* This paragraph (c)(6)(i) shall apply where the transferee is a domestic corporation, subdivision (A), (B), or (C) of this paragraph applies and subdivision (D) of this paragraph applies.

(A) Shareholders of the transferor sell, exchange or otherwise dispose of stock in the transferor at any time during a 12-month period before the date of distribution or transfer (as defined in §1.381(b)–1(b)) and the aggregate amount of such stock sold, exchanged or otherwise disposed of exceeds 25 percent of the value of the stock of the transferor, determined on a date that is 12 months before the date of distribution or transfer.

(B), (C), and (D) [Reserved]. For further guidance, see §1.884–2(c)(6)(i)(B), (C), and (D).

Where this paragraph (c)(6)(i) applies, the transferor's branch profits tax liability for the taxable year in which the section 381(a) transaction occurs shall be determined under §1.884–1, taking into account all the adjustments in U.S. net equity that result from the transfer of U.S. assets and liabilities to the transferee pursuant to the section 381(a) transaction, without regard to any provisions in this paragraph (c). If an event described in paragraph (c)(6)(i) (A), (B), or (C) of this section occurs after the close of the taxable year in which the section 381(a) transaction occurs, and if additional branch profits tax is required to be paid by reason of the application of this paragraph (c)(6)(i), then interest must be paid on that amount at the underpayment rates determined under section 6621(a)(2), with respect to the period between the date that was prescribed for filing the transferor's income tax return for the year in which the section 381(a) transaction occurs and the date on which the additional tax for that year is paid. Any such additional tax liability together with interest thereon shall be the liability of the transferee within the meaning of section 6901 pursuant to section 6901 and the regulations thereunder.

(ii) *Operating rule.* For purposes of paragraph (c)(6)(i) of this section paragraphs (a)(2) (iii)(B), (iv) and (v) of this section shall apply for purposes of making the determinations under paragraph (c)(6)(i)(D) of this section.

(d) *Incorporation under section 351*—(1) *In general.* The following rules apply to the transfer by a foreign corporation engaged (or deemed engaged) in the conduct of a U.S. trade or business (the ''transferor'') of part or all of its U.S. assets to a U.S. corporation (the ''transferee'') in exchange for stock or securities in the transferee in a transaction that qualifies under section 351(a) (a ''section 351 transaction''), provided that immediately after the transaction, the transferor is in control (as defined in section 368(c)) of the transferee, without regard to other transferors.

(2) *Inapplicability of paragraph (a)(1) of this section to section 351 transactions.* Paragraph (a)(1) of this section does not apply to exempt the transferor

from branch profits tax liability for the taxable year in which a section 351 transaction described in paragraph (d)(1) of this section occurs and shall not apply for any subsequent taxable year of the transferor in which it, or a successor-in-interest, owns stock or securities of a transferee as of the close of the transferor's taxable year.

(3) *Transferor's dividend equivalent amount for the taxable year in which a section 351 transaction occurs.* The dividend equivalent amount of the transferor for the taxable year in which a section 351 transaction described in paragraph (d)(1) of this section occurs shall be determined under the provisions of §1.884–1, as modified by the provisions of this paragraph (d)(3) provided that the transferee elects under paragraph (d)(4) of this section to be allocated a proportionate amount of the transferor's effectively connected earnings and profits and non-previously taxed accumulated effectively connected earnings and profits and the foreign corporation files a statement as provided in paragraph (d)(5)(i) of this section and complies with the agreement included in such statement with respect to a subsequent disposition of the transferee's stock.

(i) *U.S. net equity.* The transferor's U.S. net equity as of the close of the taxable year shall be determined without regard to any transfer in that taxable year of U.S. assets to or from the transferee pursuant to a section 351 transaction, and without regard to any U.S. liabilities assumed or acquired by the transferee from the transferor in that taxable year pursuant to a section 351 transaction. The transferor's adjusted basis for earnings and profits purposes in U.S. assets transferred to the transferee pursuant to a section 351 transaction shall be the adjusted basis of those assets for earnings and profits purposes immediately prior to the section 351 transaction, increased by the amount of any gain recognized by the transferor on the transfer of such assets in the section 351 transaction to the extent taken into account for earnings and profits purposes.

(ii) *Effectively connected earnings and profits.* Subject to the limitation in paragraph (d)(3)(iii) of this section, the calculation of the transferor's dividend equivalent amount shall take into account the transferor's effectively connected earnings and profits for the taxable year in which a section 351 transaction occurs (including any amount of gain recognized to the transferor pursuant to the section 351 transaction to the extent the gain is taken into account for earnings and profits purposes) and, for purposes of applying the limitation of §1.884–1(b)(3)(ii), its non-previously taxed accumulated effectively connected earnings and profits, determined without regard to the allocation to the transferee of the transferor's effectively connected earnings and profits and non-previously taxed accumulated effectively connected earnings and profits pursuant to the election under paragraph (d)(4)(i) of this section.

(iii) *Limitation on dividend equivalent amount.* The dividend equivalent amount determined under this paragraph (d)(3) shall not exceed the sum of the transferor's effectively connected earnings and profits and non-previously taxed accumulated effectively connected earnings and profits determined after taking into account the allocation to the transferee of the transferor's earnings pursuant to an election under paragraph (d)(4)(i) of this section.

(4) *Election to increase earnings and profits*—(i) *General rule.* The election referred to in paragraph (d)(3) of this section is an election by the transferee to increase its earnings and profits by the amount determined under paragraph (d)(4)(ii) of this section. An election under this paragraph (d)(4)(i) shall be effective only if the transferee attaches a statement to its timely filed (including extensions) income tax return for the taxable year in which the section 351 transaction occurs, in which—

(A) It agrees to be subject to the rules of paragraph (c)(4) (ii) and (iii) of this section with respect to the transferor's effectively connected earnings and profits and non-previously taxed accumulated effectively connected earnings and profits allocated to the transferee pursuant to the election under this paragraph (d)(4)(i) in the same manner as if such earnings and profits had been carried over to the

transferee pursuant to section 381 (a) and (c)(2), and

(B) It identifies the amount of effectively connected earnings and profits and non-previously taxed accumulated effectively connected earnings and profits that are allocated from the transferor.

An election with respect to a taxable year ending on or before December 1, 1988, may be made by filing an amended Form 1120F on or before January 3, 1988, to which the statement described in this paragraph (d)(4)(i) shall be attached.

(ii) *Amount of the transferor's effectively connected earnings and profits and non-previously taxed accumulated effectively connected earnings and profits allocated to the transferee.* The amount referred to in paragraph (d)(4)(i) of this section is equal to the same proportion of the transferor's effectively connected earnings and profits and non-previously taxed accumulated effectively connected earnings and profits (determined immediately prior to the section 351 transaction and without regard to this paragraph (d)(4) or any dividend equivalent amount for the taxable year) that the adjusted bases for purposes of computing earnings and profits in all the U.S. assets transferred to the transferee by the transferor pursuant to the section 351 transaction bear to the adjusted bases for purposes of computing earnings and profits in all the U.S. assets of the transferor, determined immediately prior to the section 351 transaction.

(iii) *Effect of election on transferor.* For purposes of computing the transferor's dividend equivalent amount for the taxable year succeeding the taxable year in which a section 351 transaction occurs, the transferor's effectively connected earnings and profits and non-previously taxed accumulated effectively connected earnings and profits as of the close of the taxable year in which the section 351 transaction occurs shall be reduced by the amount of its effectively connected earnings and profits and non-previously taxed accumulated effectively connected earnings and profits allocated to the transferee pursuant to the election under paragraph (d)(4)(i) of this section (and by its dividend equivalent amount for the taxable year in which the section 351 transaction occurs).

(5) *Dispositions of stock or securities of the transferee by the transferor*—(i) *General rule.* The statement referred to in paragraph (d)(3) of this section is a statement executed by the transferor stating the transferor's agreement that, upon the disposition of part or all of the stock or securities it owns in the transferee (or a successor-in-interest), it shall treat as a dividend equivalent amount for the taxable year in which the disposition occurs an amount equal to the lesser of (A) the amount realized upon such disposition or (B) the total amount of effectively connected earnings and profits and non-previously taxed accumulated effectively connected earnings and profits that was allocated from the transferor to that transferee pursuant to an election under paragraph (d)(4)(i) of this section, which amount shall be reduced to the extent previously taken into account by the transferor as dividends or dividend equivalent amounts for tax or branch profits, tax purposes. The extent and manner in which such dividend equivalent amount may be subject to the branch profits tax in the taxable year of disposition shall be determined under the provisions of section 884 and the regulations thereunder, including the provisions of paragraph (a) of this section (relating to complete terminations), as limited under paragraph (d)(2) of this section. Except as otherwise provided in paragraph (d)(5)(ii) of this section, the term *disposition* means any transfer that would constitute a disposition by the transferor for any purpose of the Internal Revenue Code and the regulations thereunder. This paragraph (d)(5)(i) shall apply regardless of whether the stock or securities of the transferee are U.S. assets in the hands of the transferor at the time of sale, exchange or disposition.

(ii) *Exception for certain tax-free dispositions.* For purposes of paragraph (d)(5)(i) of this section, a disposition does not include a transfer of stock or securities of the transferee by the transferor in a transaction that qualifies as a transfer pursuant to a complete liquidation described in section

332(b) or a transfer pursuant to a reorganization described in section 368(a)(1)(F). Any other transfer that qualifies for non-recognition of gain or loss shall be treated as a disposition for purposes of paragraph (d)(5)(i) of this section, unless the Commissioner has, by published guidance or by prior ruling issued to the taxpayer upon its request, determined such transfer not to be a disposition for purposes of paragraph (d)(5)(i) of this section.

(iii) *Distributions governed by section 355.* In the case of a distribution or exchange of stock or securities of a transferee to which section 355 applies (or so much of section 356 as relates to section 355) and that is not in pursuance of a plan meeting the requirements of a reorganization as defined in section 368(a)(1)(D), § 1.312–10(b) (relating to the allocation of earnings and profits in certain corporate separations) shall not apply to reduce the transferor's effectively connected earnings and profits or non-previously taxed accumulated effectively connected earnings and profits.

(iv) *Filing of statement.* The statement referred to in paragraph (d)(5)(i) of this section shall be attached to a timely filed (including extensions) income tax return of the transferor for the taxable year in which the section 351 transaction occurs. An election with respect to a taxable year ending on or before December 1, 1988, may be made by filing an amended Form 1120F on or before January 3, 1988, to which the statement described in this paragraph (d)(5)(iv) shall be attached.

(6) *Example.* The provisions of this paragraph (d) are illustrated by the following example.

Example. Foreign corporation X has a calendar taxable year. X's only assets are U.S. assets and X computes its interest deduction using the actual ratio of liabilities to assets under § 1.882–5(b)(2)(ii). X's U.S. net equity as of the close of its 1988 taxable year is $2,000, resulting from the following amounts of U.S. assets and liabilities:

U.S. assets		U.S. liabilities	
U.S. building A	$l,000	Mortgage A	800
U.S. building B	2,500	Mortgage B	1,500
Other U.S. assets	800		
Total	4,300		2,300

Assume that X's adjusted basis in its assets is equal to X's adjusted basis in its assets for earnings and profits purposes. On September 30, 1989, X transfers building A, which has a fair market value of $1,800, to a newly created U.S. corporation Y under section 351 in exchange for 100% of the stock of Y with a fair market value of $800, other property with a fair market value of $200, and the assumption of Mortgage A. Assume that under sections 11 and 351(b), tax of $30 is imposed with respect to the $200 of other property received by X. X's non-previously taxed accumulated effectively connected earnings and profits as of the close of its 1988 taxable year are $200 and its effectively connected earnings and profits for its 1989 taxable year are $330, including $170 of gain recognized to X on the transfer as adjusted for earnings and profits purposes (*i.e.,* $200 of gain recognized minus $30 of tax paid with respect to the gain). Y takes a $1,200 basis in the building transferred from X, equal to the basis in the hands of X ($1,000) increased by the amount of gain recognized to X in the section 351 transaction ($200). Y makes an election in the manner described in paragraph (d)(4)(i) of this section to increase its earnings and profits by the amount described in paragraph (d)(4)(ii) of this section and X files a statement as provided in paragraph (d)(5)(i) of this section. The branch profits tax consequences to X and Y in the taxable year in which the section 351 transaction occurs and in subsequent taxable years are as follows:

(i) *X's dividend equivalent amount for 1989.* The determination of X's dividend equivalent amount for 1989 is a three-step process: determining X's U.S. net equity as of the close of its 1989 taxable year under paragraph (d)(3)(i) of this section; determining the amount of X's effectively connected earnings and profits and non-previously taxed accumulated effectively connected earnings and profits for its 1989 taxable year under paragraph (d)(3)(ii) of this section; and applying the limitation in paragraph (d)(3)(iii) of this section.

Step one: Pursuant to paragraph (d)(3)(i) of this section, X's U.S. net equity as of the close of its 1989 taxable year is calculated without regard to the section 351 transaction except that X's basis in its U.S. assets is increased by the $170 amount of gain it has recognized for earnings and profits purposes in connection with the section 351 transaction. Thus, X's U.S. net equity as of the close of its 1989 taxable year is $1,870, consisting of the following U.S. assets and liabilities, taking into account the fact that X's other U.S. assets have decreased to $500:

U.S. assets		U.S. liabilities	
Building A	$l,170	Mortgage A	800
Building B	2,500	Mortgage B	1,500

U.S. assets		U.S. liabilities	
Other U.S. assets	500		
Total	4,170		2,300

Thus, X's U.S. net equity as of the close of its 1989 taxable year has decreased by $130 relative to its U.S. net equity as of the close of its 1988 taxable year.

Step two: Pursuant to paragraph (d)(3)(ii) of this section, X's effectively connected earnings and profits and non-previously taxed accumulated effectively connected earnings and profits for the taxable year are determined without taking into account the allocation to Y of X's effectively connected earnings and profits and non-previously taxed accumulated effectively connected earnings and profits pursuant to the election under paragraph (d)(4)(i) of this section. Thus, X's effectively connected earnings and profits for its 1989 taxable year are $330 and X's non-previously taxed accumulated effectively connected earnings and profits are $200. Thus, but for the limitation in paragraph (d)(3)(iii) of this section, X's dividend equivalent amount for the taxable year would be $460, equal to X's effectively connected earnings and profits for the taxable year ($330), increased by the decrease in X's U.S. net equity ($130).

Step three: Pursuant to paragraph (d)(3)(iii) of this section, X's dividend equivalent amount for its 1989 taxable year may not exceed the sum of the transferor's effectively connected earnings and profits and non-previously taxed accumulated effectively connected earnings and profits, determined as of the close of its 1989 taxable year, after taking into account the allocation of the transferor's earnings and profits pursuant to the election under paragraph (d)(4)(i) of this section. Based upon subdivision (ii) of this example, X's dividend equivalent amount for 1989 cannot exceed $423, which is equal to the total amount of X's effectively connected earnings and profits and non-previously taxed accumulated effectively connected earnings and profits, determined as of the close of its 1989 taxable year without regard to the allocation of earnings and profits to Y pursuant to Y's election under paragraph (d)(4)(i) of this section ($530), reduced by the amount of X's effectively connected earnings and profits and non-previously taxed accumulated effectively connected earnings and profits allocated to Y pursuant to Y's election under paragraph (d)(4)(i) of this section ($107). Thus, X's dividend equivalent amount for its 1989 taxable year is limited to $423.

(ii) *Amount of X's effectively connected earnings and profits and non-previously taxed accumulated effectively connected earnings and profits transferred to Y.* Pursuant to Y's election under paragraph (d)(4)(i) of this section, Y increases its earnings and profits by the amount prescribed in paragraph (d)(4)(ii) of this section. This amount is equal to the sum of X's effectively connected earnings and profits and non previously taxed accumulated effectively connected earnings and profits determined immediately before the section 351 transaction, without regard to X's dividend equivalent amount for the year, allocated in the same proportion that X's basis in the U.S. assets transferred to Y bears to the bases of all of X's U.S. assets, which bases are determined immediately prior to the section 351(a) transaction. The amount of X's effectively connected earnings and profits immediately before the section 351 transaction is assumed to be $260. The total amount of effectively connected earnings and profits ($260) and non-previously taxed accumulated effectively connected earnings and profits ($200) determined immediately before the section 351 transaction is, therefore, $460. The portion of $460 that is allocated to Y pursuant to Y's election under paragraph (d)(4)(i) of this section is $107, calculated as $46? multiplied by a fraction, the numerator of which is the basis of the U.S. assets transferred to Y pursuant to the section 351 transaction ($1,000), and the denominator of which is the basis of X's U.S. assets determined immediately before the section 351 transaction ($4,300). Pursuant to paragraph (d)(4)(i) of this section, the amount of $107 of X's effectively connected earnings and profits and non-previously taxed accumulated effectively connected earnings and profits allocated to Y pursuant to paragraph (d)(4)(i) of this section constitutes non-previously taxed accumulated effectively connected earnings and profits of Y.

(iii) *X's non-previously taxed accumulated effectively connected earnings and profits for 1990.* Pursuant to paragraph (d)(4)(iii) of this section, X's non-previously taxed accumulated effectively connected earnings and profits as of the close of its 1989 taxable year for purposes of computing its dividend equivalent amount for its taxable year 1990 are zero, *i.e.*, $530 of effectively connected earnings and profits and non-previously taxed accumulated effectively connected earnings and profits reduced by $107 of effectively connected earnings and profits and non-previously taxed accumulated effectively connected earnings and profits allocated to Y, and further reduced by X's $423 dividend equivalent amount for its 1989 taxable year.

(iv) *X's U.S. net equity for purposes of determining the dividend equivalent amount for succeeding taxable years.* For 1990, X must determine its U.S. net equity as of December 31, 1989, in order to determine whether there has been an increase or decrease in its U.S. net equity as of December 31, 1990. For this purpose, X's U.S. net equity as of December 31, 1989 is determined under the provisions of §1.884–1 without regard to the special rules in paragraph (d)(3)(i) of this section. Thus,

X.'s U.S. net equity as of December 31, 1989 is $1,500, consisting of the following. U.S. assets and liabilities:

U.S. assets		U.S. liabilities	
Building B	$2,500	Mortgage B	1,500
Other U.S. assets	500		
Total	$3,000		1,500

(e) *Certain transactions with respect to a domestic subsidiary*. In the case of a section 381(a) transaction in which a domestic subsidiary of a foreign corporation transfers assets to that foreign corporation or to another foreign corporation with respect to which the first foreign corporation owns stock (directly or indirectly) meeting the requirements of section 1504(a)(2), the transferee's non-previously taxed accumulated effectively connected earnings and profits for the taxable year in which the section 381(a) transaction occurs shall be increased by all of the domestic subsidiary's current earnings and profits and earnings and profits accumulated after December 31, 1986, that carry over to the transferee under sections 381(a) and (c)(1) (including non-previously taxed accumulated effectively connected earnings and profits, if any, transferred to the domestic subsidiary under paragraphs (c)(4) and (d)(4) of this section and treated as earnings and profits under paragraphs (c)(4)(ii) and (d)(4)(ii) of this section). For purposes of determining the transferee's dividend equivalent amount for the taxable year in which the section 381(a) transaction occurs, the transferee's U.S. net equity as of the close of its taxable year immediately preceding the taxable year during which the section 381(a) transaction occurs shall be increased by the greater of

(1) The amount by which the transferee's U.S. net equity computed immediately prior to the transfer would have increased due to the transfer of the subsidiary's assets and liabilities if U.S. net equity were computed immediately prior to the transfer and immediately after the transfer (taking into account in the earnings and profits basis of the assets transferred any gain recognized on the transfer to the extent reflected in earnings and profits), or

(2) The total amount of U.S net equity transferred (directly or indirectly) by the foreign parent to the domestic subsidiary in one or more prior section 351 or 381(a) transactions.

(f) *Effective date*. This section is effective for taxable years beginning after December 31, 1986.

[T.D. 8223, 53 FR 34059, Sept. 2, 1988, as amended by T.D. 8432, 57 FR 41659, Sept. 11, 1992; 57 FR 49117, Oct. 29, 1993; 57 FR 60126, Dec. 18, 1992; T.D. 8657, 61 FR 9341, Mar. 8, 1996; T.D. 9243, 71 FR 4293, Jan. 26, 2006]

§ 1.884–3T Coordination of branch profits tax with second-tier withholding (temporary). [Reserved]

§ 1.884–4 Branch-level interest tax.

(a) *General rule*—(1) *Tax on branch interest*. In the case of a foreign corporation that, during the taxable year, is engaged in trade or business in the United States or has gross income that is ECI (as defined in § 1.884–1(d)(1)(iii)), any interest paid by such trade or business (hereinafter ''branch interest,'' as defined in paragraph (b) of this section) shall, for purposes of subtitle A (Income Taxes), be treated as if it were paid by a domestic corporation (other than a corporation described in section 861(c)(1), relating to a domestic corporation that meets the 80 percent foreign business requirement). Thus, for example, whether such interest is treated as income from sources within the United States by the person who receives the interest shall be determined in the same manner as if such interest were paid by a domestic corporation (other than a corporation described in section 861(c)(1)). Such interest shall be subject to tax under section 871(a) or 881, and to withholding under section 1441 or 1442, in the same manner as interest paid by a domestic corporation (other than a corporation described in section 861(c)(1)) if received by a foreign person and not effectively connected with the conduct by the foreign person of a trade or business in the United States, unless the interest, if paid by a domestic corporation, would be exempt under section 871(h) or 881(c) (relating to exemption for certain portfolio interest received by a foreign person), section 871(i) or 881(d) (relating, in part, to exemption

for certain bank deposit interest received by a foreign person), or another provision of the Code. Such interest shall also be treated as interest paid by a domestic corporation (other than a corporation described in section 861(c)(1)) for purposes of sections 864(c), 871(b) and 882(a) (relating to income that is effectively connected with the conduct of a trade or business within the United States) and section 904 (relating to the limitation on the foreign tax credit). For purposes of this section, a foreign corporation also shall be treated as engaged in trade or business in the United States if, at any time during the taxable year, it owns an asset taken into account under §1.882–5(a)(1)(ii) or (b)(1) for purposes of determining the amount of the foreign corporation's interest expense allocated or apportioned to ECI. See paragraph (b)(8) of this section for the effect of income tax treaties on branch interest.

(2) *Tax on excess interest*—(i) Definition of excess interest. For purposes of this section, the term ''excess interest'' means—

(A) The amount of interest allocated or apportioned to ECI of the foreign corporation under §1.882–5 for the taxable year, after application of §1.884–1(e)(3); minus

(B) The foreign corporation's branch interest (as defined in paragraph (b) of this section) for the taxable year, but not including interest accruing in a taxable year beginning before January 1, 1987; minus

(C) The amount of interest determined under paragraph (c)(2) of this section (relating to interest paid by a partnership).

(ii) *Imposition of tax*. A foreign corporation shall be liable for tax on excess interest under section 881(a) in the same manner as if such excess interest were interest paid to the foreign corporation by a wholly-owned domestic corporation (other than a corporation described in section 861(c)(1)) on the last day of the foreign corporation's taxable year. Excess interest shall be exempt from tax under section 881(a) only as provided in paragraph (a)(2)(iii) of this section (relating to treatment of certain excess interest of banks as interest on deposits) or paragraph (c)(3) of this section (relating to income tax treaties).

(iii) *Treatment of a portion of the excess interest of banks as interest on deposits*. A portion of the excess interest of a foreign corporation that is a bank (as defined in section 585(a)(2)(B) without regard to the second sentence thereof) provided that a substantial part of its business in the United States, as well as all other countries in which it operates, consists of receiving deposits and making loans and discounts, shall be treated as interest on deposits (as described in section 871(i)(3)), and shall be exempt from the tax imposed by section 881(a) as provided in such section. The portion of the excess interest of the foreign corporation that is treated as interest on deposits shall equal the product of the foreign corporation's excess interest and the greater of—

(A) The ratio of the amount of interest bearing deposits, within the meaning of section 871(i)(3)(A), of the foreign corporation as of the close of the taxable year to the amount of all interest bearing liabilities of the foreign corporation on such date; or

(B) 85 percent.

(iv) *Reporting and payment of tax on excess interest*. The amount of tax due under section 884(f) and this section with respect to excess interest of a foreign corporation shall be reported on the foreign corporation's income tax return for the taxable year in which the excess interest is treated as paid to the foreign corporation under section 884(f)(1)(B) and paragraph (a)(2) of this section, and shall not be subject to withholding under section 1441 or 1442. The tax shall be due and payable as provided in section 6151 and such other sections of Subtitle F of the Internal Revenue Code as apply, and estimated tax payments shall be due with respect to a foreign corporation's liability for the tax on excess interest as provided in section 6655.

(3) *Original issue discount*. For purposes of this section, the term ''interest'' includes original issue discount, as defined in section 1273(a)(1).

(4) *Examples*. The application of this paragraph (a) is illustrated by the following examples.

Example 1. Taxation of branch interest and excess interest. Foreign corporation A, a calendar year taxpayer that is not a corporation described in paragraph (a)(2)(iii) of this section (relating to banks), has $120 of interest allocated or apportioned to ECI under § 1.882–5 for 1997. A's branch interest (as defined in paragraph (b) of this section) for 1997 is as follows: $55 of portfolio interest (as defined in section 871(h)(2)) to B, a nonresident alien; $25 of interest to foreign corporation C, which owns 15 percent of the combined voting power of A's stock, with respect to bonds issued by A; and $20 to D, a domestic corporation. B and C are not engaged in the conduct of a trade or business in the United States. A, B and C are residents of countries with which the United States does not have an income tax treaty. The interest payments made to B and D are not subject to tax under section 871(a) or 881 and are not subject to withholding under section 1441 or 1442. The payment to C, which does not qualify as portfolio interest because C owns at least 10 percent of the combined voting power of A's stock, is subject to withholding of $7.50 ($25 × 30%). In addition, because A's interest allocated or apportioned to ECI under § 1.882–5 ($120) exceeds its branch interest ($100), A has excess interest of $20, which is subject to a tax of $6 ($20 × 30%) under section 881. The tax on A's excess interest must be reported on A's income tax return for 1997.

Example 2. Taxation of excess interest of a bank. Foreign corporation A, a calendar year taxpayer, is a corporation described in paragraph (a)(2)(iii) of this section (relating to banks) and is a resident of a country with which the United States does not have an income tax treaty. A has excess interest of $100 for 1997. At the close of 1997, A has $10,000 of interest-bearing liabilities (including liabilities that give rise to branch interest), of which $8,700 are interest-bearing deposits. For purposes of computing the tax on A's excess interest, $87 of the excess interest ($100 excess interest × ($8,700 interest-bearing deposits/$10,000 interest-bearing liabilities)) is treated as interest on deposits. Thus, $87 of A's excess interest is exempt from tax under section 881(a) and the remaining $13 of excess interest is subject to a tax of $3.90 ($13 × 30%) under section 881(a).

(b) *Branch interest*—(1) *Definition of branch interest.* For purposes of this section, the term ''branch interest'' means interest that is—

(i) Paid by a foreign corporation with respect to a liability that is—

(A) A U.S. booked liability within the meaning of § 1.882–5(d)(2) (other than a U.S. booked liability of a partner within the meaning of § 1.882–5(d)(2)(vii)); or

(B) Described in § 1.884–1(e)(2) (relating to insurance liabilities on U.S. business and liabilities giving rise to interest expense that is directly allocated to income from a U.S. asset); or

(ii) In the case of a foreign corporation other than a corporation described in paragraph (a)(2)(iii) of this section, a liability specifically identified (as provided in paragraph (b)(3)(i) of this section) as a liability of a U.S. trade or business of the foreign corporation on or before the earlier of the date on which the first payment of interest is made with respect to the liability or the due date (including extensions) of the foreign corporation's income tax return for the taxable year, provided that—

(A) The amount of such interest does not exceed 85 percent of the amount of interest of the foreign corporation that would be excess interest before taking into account interest treated as branch interest by reason of this paragraph (b)(1)(ii);

(B) The requirements of paragraph (b)(3)(ii) of this section (relating to notification of recipient of interest) are satisfied; and

(C) The liability is not described in paragraph (b)(3)(iii) of this section (relating to liabilities incurred in the ordinary course of a foreign business or secured by foreign assets) or paragraph (b)(1)(i) of this section.

(2) [Reserved]

(3) *Requirements relating to specifically identified liabilities*—(i) *Method of identification.* A liability described in paragraph (b)(1)(ii) of this section is identified as a liability of a U.S. trade or business only if the liability is shown on the records of the U.S. trade or business, or is identified as a liability of the U.S. trade or business on other records of the foreign corporation or on a schedule established for the purpose of identifying the liabilities of the U.S. trade or business. Each such liability must be identified with sufficient specificity so that the amount of branch interest attributable to the liability, and the name and address of the recipient, can be readily identified from such records or schedule. However, with respect to liabilities that give rise to portfolio interest (as defined in sections 871(h) and 881(c)) or that are payable 183 days or less from the date of original issue, and form part of a larger

debt issue, such liabilities may be identified by reference to the issue and maturity date, principal amount and interest payable with respect to the entire debt issue. Records or schedules described in this paragraph that identify liabilities that give rise to branch interest must be maintained in the United States by the foreign corporation or an agent of the foreign corporation for the entire period commencing with the due date (including extensions) of the income tax return for the taxable year to which the records or schedules relate and ending with the expiration of the period of limitations for assessment of tax for such taxable year. A foreign corporation that is subject to this section may identify a liability under paragraph (b)(1)(ii) of this section whether or not it is actually engaged in the conduct of a trade or business in the United States.

(ii) *Notification to recipient.* Interest with respect to a liability described in paragraph (b)(1)(ii) of this section shall not be treated as branch interest unless the foreign corporation paying the interest either—

(A) Makes a return, pursuant to section 6049, with respect to the interest payment; or

(B) Sends a notice to the person who receives such interest in a confirmation of the transaction, a statement of account, or a separate notice, within two months of the end of the calendar year in which the interest was paid, stating that the interest paid with respect to the liability is from sources within the United States.

(iii) *Liabilities that do not give rise to branch interest under paragraph (b)(1)(ii) of this section.* A liability is described in this paragraph (b)(3)(iii) (and interest with respect to the liability may not be treated as branch interest of a foreign corporation by reason of paragraph (b)(1)(ii) of this section) if—

(A) The liability is directly incurred in the ordinary course of the profit-making activities of a trade or business of the foreign corporation conducted outside the United States, as, for example, an account or note payable arising from the purchase of inventory or receipt of services by such trade or business; or

(B) The liability is secured (during more than half the days during the portion of the taxable year in which the interest accrues) predominantly by property that is not a U.S. asset (as defined in §1.884–1(d)) unless such liability is secured by substantially all the property of the foreign corporation.

(4) [Reserved]

(5) *Increase in branch interest where U.S. assets constitute 80 percent or more of a foreign corporation's assets*—(i) *General rule.* If a foreign corporation would have excess interest before application of this paragraph (b) (5) and the amount of the foreign corporation's U.S. assets as of the close of the taxable year equals or exceeds 80 percent of all money and the aggregate E&P basis of all property of the foreign corporation on such date, then all interest paid and accrued by the foreign corporation during the taxable year that was not treated as branch interest before application of this paragraph (b)(5) and that is not paid with respect to a liability described in paragraph (b)(3)(iii) of this section (relating to liabilities incurred in the ordinary course of a foreign business or secured by non-U.S. assets) shall be treated as branch interest. However, if application of the preceding sentence would cause the amount of the foreign corporation's branch interest to exceed the amount permitted by paragraph (b)(6)(i) of this section (relating to branch interest in excess of a foreign corporation's interest allocated or apportioned to ECI under §1.882–5) the amount of branch interest arising by reason of this paragraph shall be reduced as provided in paragraphs (b)(6)(ii) and (iii) of this section, as applicable.

(ii) *Example.* The application of this paragraph (b)(5) is illustrated by the following example.

Example. Application of 80 percent test. Foreign corporation A, a calendar year taxpayer, has $90 of interest allocated or apportioned to ECI under §1.882–5 for 1993. Before application of this paragraph (b)(5), A has $40 of branch interest in 1993. A pays $60 of other interest during 1993, none of which is attributable to a liability described in paragraph (b)(3)(iii) of this section (relating to liabilities incurred in the ordinary course of a foreign business and liabilities predominantly secured by foreign assets). As of the close of

1993, A has an amount of U.S. assets that exceeds 80 percent of the money and E&P bases of all A's property. Before application of this paragraph (b)(5), A would have $50 of excess interest (i.e., the $90 interest allocated or apportioned to its ECI under § 1.882–5 less $40 of branch interest). Under this paragraph (b)(5), the $60 of additional interest paid by A is also treated as branch interest. However, to the extent that treating the $60 of additional interest as branch interest would create an amount of branch interest that would exceed the amount of branch interest permitted under paragraph (b)(6) of this section (relating to branch interest that exceeds a foreign corporation's interest allocated or apportioned to ECI under § 1.882–5) the amount of the additional branch interest is reduced under paragraph (b)(6)(iii) of this section, which generally allows a foreign corporation to specify certain liabilities that do not give rise to branch interest or paragraph (b) (6) (ii) of this section, which generally specifies liabilities that do not give rise to branch interest beginning with the most-recently incurred liability.

(6) *Special rule where branch interest exceeds interest allocated or apportioned to ECI of a foreign corporation*—(i) *General rule*. If the amount of branch interest that is both paid and accrued by a foreign corporation during the taxable year (including interest that the foreign corporation elects under paragraph (c)(1) of this section to treat as paid during the taxable year) exceeds the amount of interest allocated or apportioned to ECI of a foreign corporation under § 1.882–5 for the taxable year, then the amount of the foreign corporation's branch interest shall be reduced by the amount of such excess as provided in paragraphs (b)(6)(ii) and (iii) of this section, as applicable. The rules of paragraphs (b)(6)(ii) and (iii) of this section shall also apply where the amount of branch interest with respect to liabilities identified under paragraph (b)(1)(ii) of this section exceeds the maximum amount that may be treated as branch interest under that paragraph. This paragraph (b)(6) shall apply whether or not a reduction in the amount of branch interest occurs as a result of adjustments made during the examination of the foreign corporation's income tax return, such as a reduction in the amount of interest allocated or apportioned to ECI of the foreign corporation under § 1.882–5.

(ii) *Reduction of branch interest beginning with most-recently incurred liability*. Except as provided in paragraph (b)(6)(iii) of this section (relating to an election to specify liabilities that do not give rise to branch interest), the amount of the excess in paragraph (b)(6)(i) of this section shall first reduce branch interest attributable to liabilities described in paragraph (b)(1)(ii) of this section (relating to liabilities identified as giving rise to branch interest) and then, if such excess has not been reduced to zero, branch interest attributable to the group of liabilities described in paragraph (b)(1)(i) of this section. The reduction of branch interest attributable to each group of liabilities (i.e., liabilities described in paragraph (b)(1)(ii) of this section and liabilities described in paragraph (b)(1)(i) of this section) shall be made beginning with interest attributable to the latest-incurred liability and continuing, in reverse chronological order, with branch interest attributable to the next-latest incurred liability. The branch interest attributable to a liability must be reduced to zero before a reduction is made with respect to branch interest attributable to the next-latest incurred liability. Where only a portion of the branch interest attributable to a liability is reduced by reason of this paragraph (b)(6)(ii), the reduction shall be made beginning with the last interest payment made with respect to the liability during the taxable year and continuing, in reverse chronological order, with the next-latest payment until the amount of branch interest has been reduced by the amount specified in paragraph (b)(6)(i) of this section. The amount of interest that is not treated as branch interest by reason of this paragraph (b)(6)(ii) shall not be treated as paid by a domestic corporation and thus shall not be subject to tax under section 871(a) or 881(a).

(iii) *Election to specify liabilities that do not give rise to branch interest*. For purposes of reducing the amount of branch interest under paragraph (b)(6)(i) of this section, a foreign corporation may, instead of using the method described in paragraph (b)(6)(ii) of this section, elect for any taxable year to specify which liabilities will not be treated as giving rise to branch interest or will be treated as giving

rise only in part to branch interest. Branch interest paid during the taxable year with respect to a liability specified under this paragraph (b)(6)(iii) must be reduced to zero before a reduction is made with respect to branch interest attributable to the next-specified liability. If all interest payments with respect to a specified liability, when added to all interest payments with respect to other liabilities specified under this paragraph (b)(6)(iii), would exceed the amount of the reduction under paragraph (b)(6)(i) of this section, then only a portion of the branch interest attributable to that specified liability shall be reduced under this paragraph (b)(6)(iii), and the reduction shall be made beginning with the last interest payment made with respect to the liability during the taxable year and continuing, in reverse chronological order, with the next-latest payment until the amount of branch interest has been reduced by the amount of the reduction under paragraph (b)(6)(i) of this section. A foreign corporation that elects to have this paragraph (b)(6)(iii) apply shall note on its books and records maintained in the United States that the liability is not to be treated as giving rise to branch interest, or is to be treated as giving rise to branch interest only in part. Such notation must be made after the close of the taxable year in which the foreign corporation pays the interest and prior to the due date (with extensions) of the foreign corporation's income tax return for the taxable year. However, if the excess interest in paragraph (b)(6)(i) of this section occurs as a result of adjustments made during the examination of the foreign corporation's income tax return, the election and notation may be made at the time of examination. The amount of interest that is not treated as branch interest by reason of this paragraph (b)(6)(iii) shall not be treated as paid by a domestic corporation and thus shall not be subject to tax under section 871 (a) or 881 (a).

(iv) *Examples*. The application of this paragraph (b)(6) is illustrated by the following examples.

Example 1. Branch interest exceeds interest apportioned to ECI with no election in effect. Foreign corporation A, a calendar year, accrual method taxpayer, has interest expense apportioned to ECI under §1.882–5 of $230 for 1997. A's branch interest for 1997 is as follows:

(i) $130 paid to B, a domestic corporation, with respect to a note issued on March 10, 1997, and secured by real property located in the United States;

(ii) $60 paid to C, an individual resident of country X who is entitled to a 10 percent rate of withholding on interest payments under the income tax treaty between the United States and X, with respect to a note issued on October 15, 1996, which gives rise to interest subject to tax under section 871(a);

(iii) $80 paid to D, an individual resident of country Y who is entitled to a 15 percent rate of withholding on interest payments under the income tax treaty between the United States and Y, with respect to a note issued on February 15, 1997, which gives rise to interest subject to tax under section 871(a); and

(iv) $70 of portfolio interest (as defined in section 871(h) (2)) paid to E, a nonresident alien, with respect to a bond issued on March 1, 1997.

A's branch interest accrues during 1997 for purposes of calculating the amount of A's interest apportioned to ECI under §1.882–5. A has identified under paragraph (b)(1)(ii) of this section the liabilities described in paragraphs (ii), (iii) and (iv) of this example. A has not made an election under paragraph (b)(6)(iii) of this section to specify liabilities that do not give rise to branch interest. The amount of A's branch interest in 1997 is limited under paragraph (b)(6)(i) of this section to $230, the amount of the interest apportioned to A's ECI for 1997. The amount of A's branch interest must thus be reduced by $110 ($340–$230) under paragraph (b)(6)(ii) of this section. The reduction is first made with respect to interest attributable to liabilities described in paragraph (b)(1)(ii) of this section (i.e., liabilities identified as giving rise to branch interest) and, within the group of liabilities described in paragraph (b)(1)(ii) of this section, is first made with respect to the latest-incurred liability. Thus, the $70 of interest paid to E with respect to the bond issued on March 1, 1997, and $40 of the $80 of interest paid to D with respect to the note issued on February 15, 1997, are not treated as branch interest. The interest paid to D is no longer subject to tax under section 871(a), and D may claim a refund of amounts withheld with respect to the interest payments. There is no change in the tax consequences to E because the interest received by E was portfolio interest and was not subject to tax when it was treated as branch interest.

Example 2. Effect of election to specify liabilities. Assume the same facts as in *Example 1* except that A makes an election under paragraph (b)(6)(iii) of this section to specify

which liabilities are not to be treated as giving rise to branch interest. A specifies the liability to D, who would be taxable at a rate of 15 percent on interest paid with respect to the liability, as a liability that does not give rise to branch interest, and D is therefore not subject to tax under section 871 (a) and is entitled to a refund of amounts withheld with respect to the interest payments. A also specifies the liability to C as a liability that gives rise to branch interest only in part. As a result, $30 of the $60 of interest paid to C is not treated as branch interest, and C is entitled to a refund with respect to the $30 of interest that is not treated as branch interest.

(7) *Effect of election under paragraph (c)(1) of this section to treat interest as if paid in year of accrual.* If a foreign corporation accrues an interest expense in a taxable year earlier than the taxable year of payment and elects under paragraph (c)(1) of this section to compute its excess interest as if the interest expense were branch interest paid in the year of accrual, the interest expense shall be treated as branch interest that is paid at the close of such year (and not in the actual year of payment) for all purposes of this section. Such interest shall thus be subject to tax under section 871(a) or 881(a) and withholding under section 1441 or section 1442, as if paid on the last day of the taxable year of accrual. Interest that is treated under paragraph (c)(1) of this section as paid in a later year for purposes of computing excess interest shall be treated as paid only in the actual year of payment for all purposes of this section other than paragraphs (a)(2) and (c)(1) of this section (relating to excess interest).

(8) *Effect of treaties*—(i) *Payor's treaty.* In the case of a foreign corporation's branch interest, relief shall be available under an article of an income tax treaty between the United States and the foreign corporation's country of residence relating to interest paid by the foreign corporation only if, for the taxable year in which the branch interest is paid (or if the branch interest is treated as paid in an earlier taxable year under paragraph (b)(7) of this section, for the earlier taxable year)—

(A) The foreign corporation meets the requirements of the limitation on benefits provision, if any, in the treaty, and either—

(*1*) The corporation is a qualified resident (as defined in §1.884–5(a)) of that foreign country in such year; or

(*2*) The corporation meets the requirements of paragraph (b)(8)(iii) of this section in such year; or

(B) The limitation on benefits provision, or an amendment to that provision, entered into force after December 31, 1986.

(ii) *Recipient's treaty.* A foreign person (other than a foreign corporation) that derives branch interest is entitled to claim benefits under provisions of an income tax treaty between the United States and its country of residence relating to interest derived by the foreign person. A foreign corporation may claim such benefits if it meets, with respect to the branch interest, the requirements of the limitation on benefits provision, if any, in the treaty and—

(A) The foreign corporation meets the requirements of paragraphs (b)(8)(i)(A) or (B) of this section; and

(B) In the case of interest paid in a taxable year beginning after December 31, 1988, with respect to an obligation with a maturity not exceeding one year, each foreign corporation that beneficially owned the obligation prior to maturity was a qualified resident (for the period specified in paragraph (b)(8)(i) of this section) of a foreign country with which the United States has an income tax treaty or met the requirements of the limitation on benefits provision in a treaty with respect to the interest payment and such provision entered into force after December 31, 1986.

(iii) *Presumption that a foreign corporation continues to be a qualified resident.* For purposes of this paragraph (b)(8), a foreign corporation that was a qualified resident for the prior taxable year because it fulfills the requirements of §1.884–5 shall be considered a qualified resident with respect to branch interest that is paid or received during the current taxable year if—

(A) In the case of a foreign corporation that met the stock ownership and base erosion tests in §1.884–5(b) and (c) for the preceding taxable year, the foreign corporation does not know, or have reason to know, that either 50 percent of its stock (by value) is not

beneficially owned (or treated as beneficially owned by reason of § 1.884–5(b)(2)) by qualifying shareholders at any time during the portion of the taxable year that ends with the date on which the interest is paid, or that the base erosion test is not met during the portion of the taxable year that ends with the date on which the interest is paid;

(B) In the case of a foreign corporation that met the requirements of § 1.884–5(d) (relating to publicly-traded corporations) for the preceding taxable year, the foreign corporation is listed on an established securities exchange in the United States or its country of residence at all times during the portion of the taxable year that ends with the date on which the interest is paid and does not fail the requirements of § 1.884–5(d)(4)(iii) (relating to certain closely-held corporations) at any time during such period; or

(C) In the case of a foreign corporation that met the requirements of § 1.884–5(e) (relating to the active trade or business test) for the preceding taxable year, the foreign corporation continues to operate (other than in a nominal degree), at all times during the portion of the taxable year that ends with the date on which the interest is paid, the same business in the U.S. and its country of residence that caused it to meet such requirements for the preceding taxable year.

(iv) *Treaties other than income tax treaties.* A treaty that is not an income tax treaty does not provide any benefits with respect to branch interest.

(v) *Effect of income tax treaties on interest paid by a partnership.* If a foreign corporation is a partner (directly or indirectly) in a partnership that is engaged in a trade or business in the United States and owns an interest of 10 percent or more (as determined under the attribution rules of section 318) in the capital, profits, or losses of the partnership at any time during the partner's taxable year, the relief that may be claimed under an income tax treaty with respect to the foreign corporation distributive share of interest paid or treated as paid by the partnership shall not exceed the relief that would be available under paragraphs (b)(8) (i) and (ii) of this section if such interest were branch interest of the foreign corporation. See paragraph (c)(2) of this section for the effect on a foreign corporation's excess interest of interest paid by a partnership of which the foreign corporation is a partner.

(vi) *Examples.* The following examples illustrate the application of this paragraph (b)(8).

Example 1. Payor's treaty. The income tax treaty between the United States and country X provides that the United States may not impose a tax on interest paid by a corporation that is a resident of that country (and that is not a domestic corporation) if the recipient of the interest is a nonresident alien or a foreign corporation. Corp A is a qualified resident of country X and meets the limitation on benefits provision in the treaty. A's branch interest is not subject to tax under section 871(a) or 881(a) regardless of whether the recipient is entitled to benefits under an income tax treaty.

Example 2. Recipient's treaty and interest received from a partnership. A, a foreign corporation, and B, a nonresident alien, are partners in a partnership that owns and operates U.S. real estate and each has a distributive share of partnership interest deductions equal to 50 percent of the interest deductions of the partnership. There is no income tax treaty between the United States and the countries of residence of A and B. The partnership pays $1,000 of interest to a bank that is a resident of a foreign country, Y, and that qualifies under an income tax treaty in effect with the United States for a 5 percent rate of tax on U.S. source interest paid to a resident of country Y. However, the bank is not a qualified resident of country Y and the limitation on benefits provision of the treaty has not been amended since December 31, 1986. The partnership is required to withhold at a rate of 30 percent on $500 of the interest paid to the bank (i.e., A's 50 percent distributive share of interest paid by the partnership) because the bank cannot, under paragraph (b)(8)(iv) of this section, claim greater treaty benefits by lending money to the partnership than it could claim, if it lent money to A directly and the $500 were branch interest of A.

(c) *Rules relating to excess interest*—(1) *Election to compute excess interest by treating branch interest that is paid and accrued in different years as if paid in year of accrual*—(i) *General rule.* If branch interest is paid in one or more taxable years before or after the year in which the interest accrues, a foreign corporation may elect to compute its excess interest as if such branch interest were paid on the last day of the

taxable year in which it accrues, and not in the taxable year in which it is actually paid. The interest expense will thus reduce the amount of the foreign corporation's excess interest in the year of accrual rather than in the year of actual payment. Except as provided in paragraph (c)(1)(ii) of this section, if an election is made for a taxable year, this paragraph (c)(1)(i) shall apply to all branch interest that is paid or accrued during that year. See paragraph (b)(7) of this section for the effect of an election under this paragraph (c)(1) on branch interest that accrues in a taxable year after the year of payment.

(ii) *Election not to apply in certain cases.* An election under this paragraph (c)(1) shall not apply to an interest expense that accrued in a taxable year beginning before January 1, 1987, and shall not apply to an interest expense that was paid in a taxable year beginning before such date unless the interest was income from sources within the United States. An election under this paragraph (c)(1) shall not apply to branch interest that accrues during the taxable year and is paid in an earlier taxable year if the branch interest reduced excess interest in such earlier year. However, a foreign corporation may amend its income tax return for such earlier taxable year so that the branch interest does not reduce excess interest in such year.

(iii) *Requirements for election.* A foreign corporation that elects to apply this paragraph (c)(1) shall attach to its income tax return (or to an amended income tax return) a statement that it elects to have the provisions of this paragraph (c)(1) apply, or shall provide written notice to the Commissioner during an examination that it elects to apply this paragraph (c)(1). The election shall be effective for the taxable year to which the return relates and for all subsequent taxable years unless the Commissioner consents to revocation of the election.

(iv) *Examples.* The following examples illustrate the application of this paragraph (c)(1).

Example 1. Interest accrued before paid. Foreign corporation A, a calendar year, accrual method taxpayer, has $100 of interest allocated or apportioned to ECI under §1.882–5 for 1997. A has $60 of branch interest in 1997 before application of this paragraph (c)(1). A has an interest expense of $20 that properly accrues for tax purposes in 1997 but is not paid until 1998. When the interest is paid in 1998 it will meet the requirements for branch interest under paragraph (b)(1) of this section. A makes a timely election under this paragraph (c)(1) to treat the accrued interest as if it were paid in 1997. A will be treated as having branch interest of $80 for 1997 and excess interest of $20 in 1997. The $20 of interest treated as branch interest of A in 1997 will not again be treated as branch interest in 1998.

Example 2. Interest paid before accrued. Foreign corporation A, a calendar year, accrual method taxpayer, has $60 of branch interest in 1997. The interest expense does not accrue until 1994 and the amount of interest allocated or apportioned to A's ECI under §1.882–5 is zero for 1997 and $60 for 1998. A makes an election under this paragraph (c)(1) with respect to 1997. As a result of the election, A's $60 of branch interest in 1997 reduces the amount of A's excess interest for 1994 rather than in 1998.

(2) *Interest paid by a partnership*—(i) *General rule.* Except as otherwise provided in paragraphs (c)(2) (i) and (ii) of this section, if a foreign corporation is a partner in a partnership that is engaged in trade or business in the United States, the amount of the foreign corporation's distributive share of interest paid or accrued by the partnership shall reduce (but not below zero) the amount of the foreign corporation's excess interest for the year to the extent such interest is taken into account by the foreign corporation in that year for purposes of calculating the interest allocated or apportioned to the ECI of the foreign corporation under §1.882–5. A foreign corporation's excess interest shall not be reduced by its distributive share of partnership interest that is attributable to a liability described in paragraph (b)(3)(iii) of this section (relating to interest on liabilities incurred in the ordinary course of a foreign business or secured predominantly by assets that are not U.S. assets) or would be described in paragraph (b)(3)(iii) of this section if entered on the partner's books. See paragraph (b)(8)(v) of this section for the effect of income tax treaties on interest paid by a partnership.

(ii) *Special rule for interest that is paid and accrued in different years.* Paragraph (c)(2)(i) of this section shall not

apply to any portion of a foreign corporation's distributive share of partnership interest that is paid and accrued in different taxable years unless the foreign corporation has an election in effect under paragraph (c)(1) of this section that is effective with respect to such interest and any tax due under section 871(a) or 881(a) with respect to such interest has been deducted and withheld at source in the earlier of the taxable year of payment or accrual.

(3) *Effect of treaties*—(i) *General rule.* The rate of tax imposed on the excess interest of a foreign corporation that is a resident of a country with which the United States has an income tax treaty shall not exceed the rate provided under such treaty that would apply with respect to interest paid by a domestic corporation to that foreign corporation if the foreign corporation meets, with respect to the excess interest, the requirements of the limitation on benefits provision, if any, in the treaty and either—

(A) The corporation is a qualified resident (as defined in §1.884–5(a)) of that foreign country for the taxable year in which the excess interest is subject to tax; or

(B) The limitation on benefits provision, or an amendment to that provision, entered into force after December 31, 1986.

(ii) *Provisions relating to interest paid by a foreign corporation.* Any provision in an income tax treaty that exempts or reduces the rate of tax on interest paid by a foreign corporation does not prevent imposition of the tax on excess interest or reduce the rate of such tax.

(4) *Example.* The application of paragraphs (c)(2) and (3) of this section is illustrated by the following example.

Example. Interest paid by a partnership. Foreign corporation A, a calendar year taxpayer, is not a resident of a foreign country with which the United States has an income tax treaty. A is engaged in the conduct of a trade or business both in the United States and in foreign countries, and owns a 50 percent interest in X, a calendar year partnership engaged in the conduct of a trade or business in the United States. For 1997, all of X's liabilities are of a type described in paragraph (b)(1) of this section (relating to liabilities on U.S. books) and none are described in paragraph (b)(3)(iii) of this section (relating to liabilities that may not give rise to branch interest). A's distributive share of interest paid by X in 1997 is $20. For 1997, A has $150 of interest allocated or apportioned to its ECI under §1.882–5, $120 of which is attributable to branch interest. Thus, the amount of A's excess interest for 1997, before application of paragraph (c)(2)(i) of this section, is $30. Under paragraph (c)(2)(i) of this section, A's $30 of excess interest is reduced by $20, representing A's share of interest paid by X. Thus, the amount of A's excess interest for 1997 is reduced to $10. A is subject to a tax of 30 percent on its $10 of excess interest.

(d) *Stapled entities.* A foreign corporation that is treated as a domestic corporation by reason of section 269B (relating to stapled entities) shall continue to be treated as a foreign corporation for purposes of section 884 (f) and this section, notwithstanding section 269B and the regulations thereunder. Interest paid by such foreign corporation shall be treated as paid by a domestic corporation and shall be subject to the tax imposed by section 871 (a) or 881 (a), and to withholding under section 1441 and 1442, as applicable, to the extent such interest is not subject to tax by reason of section 884(f) and this section.

(e) *Effective dates*—(1) *General rule.* Except as provided in paragraph (e)(2) of this section, this section is effective for taxable years beginning October 13, 1992, and for payments of interest described in section 884(f)(1)(A) made (or treated as made under paragraph (b)(7) of this section) during taxable years of the payor beginning after such date. With respect to taxable years beginning before October 13, 1992, and after December 31, 1986, a foreign corporation may elect to apply this section in lieu of §1.884–4T of the temporary regulations (as contained in the CFR edition revised as of April 1, 1992) as they applied to the foreign corporation after issuance of Notice 89–80, 1989–2 C.B. 394, but only if the foreign corporation has made an election under §1.884–1 (i) to apply §1.884–1 in lieu of §1.884–1T (as contained in the CFR edition revised as of April 1, 1992) for that year, and the statute of limitations for assessment of a deficiency has not expired for that taxable year. Once an election has been made, an election under this section shall apply to all subsequent taxable years.

(2) *Special rule.* Paragraphs (a)(1), (a)(2)(i)(A), (a)(2)(iii), (b)(1), (b)(3), (b)(5)(i), (b)(6)(i), (b)(6)(ii), and (c)(2)(i) of this section are effective for taxable years beginning on or after June 6, 1996.

(f) *Transition rules*—(1) *Election under paragraph (c)(1) of this section.* If a foreign corporation has made an election described in §1.884–4T(b)(7) (as contained in the CFR edition revised as of April 1, 1992) with respect to interest that has accrued and been paid in different taxable years, such election shall be effective for purposes of paragraph (c)(1) of this section as if the corporation had made the election under paragraph (c)(1) of this section of these regulations.

(2) *Waiver of notification requirement for non-banks under Notice 89–80.* If a foreign corporation that is not a bank has made an election under Notice 89–80 to apply the rules in part 2 of section I of the Notice in lieu of the rules in §1.884–4T(b) (as contained in the CFR edition revised as of April 1, 1992) to determine the amount of its interest paid and excess interest in taxable years beginning prior to 1990, the requirement that the foreign corporation satisfy the notification requirements described in paragraph (b)(3)(ii) of this section is waived with respect to interest paid in taxable years ending on or before the date the Notice was issued.

(3) *Waiver of legending requirement for certain debt issued prior to January 3, 1989.* For purposes of sections 871(h), 881(c), and this section, branch interest of a foreign corporation that would be treated as portfolio interest under section 871(h) or 881(c) but for the fact that it fails to meet the requirements of section 163(f)(2)(B)(ii)(II) (relating to the legend requirement), shall nevertheless be treated as portfolio interest provided the interest arises with respect to a liability incurred by the foreign corporation before January 3, 1989, and interest with respect to the liability was treated as branch interest in a taxable year beginning before January 1, 1990.

[T.D. 8432, 57 FR 41660, Sept. 11, 1992; 57 FR 49117, Oct. 29, 1992; 57 FR 60126, Dec. 18, 1992, as amended by T.D. 8657, 61 FR 9341, Mar. 8, 1996]

§1.884–5 Qualified resident.

(a) *Definition of qualified resident.* A foreign corporation is a qualified resident of a foreign country with which the United States has an income tax treaty in effect if, for the taxable year, the foreign corporation is a resident of that country (within the meaning of such treaty) and either—

(1) Meets the requirements of paragraphs (b) and (c) of this section (relating to stock ownership and base erosion);

(2) Meets the requirements of paragraph (d) of this section (relating to publicly-traded corporations);

(3) Meets the requirements of paragraph (e) of this section (relating to the conduct of an active trade or business); or

(4) Obtains a ruling as provided in paragraph (f) of this section that it shall be treated as a qualified resident of its country of residence.

(b) *Stock ownership requirement*—(1) *General rule*—(i) *Ownership by qualifying shareholders.* A foreign corporation satisfies the stock ownership requirement of this paragraph (b) for the taxable year if more than 50 percent of its stock (by value) is beneficially owned (or is treated as beneficially owned by reason of paragraph (b)(2) of this section) during at least half of the number of days in the foreign corporation's taxable year by one or more qualifying shareholders. A person shall be treated as a qualifying shareholder only if such person meets the requirements of paragraph (b)(3) of this section and is either—

(A) An individual who is either a resident of the foreign country of which the foreign corporation is a resident or a citizen or resident of the United States;

(B) The government of the country of which the foreign corporation is a resident (or a political subdivision or local authority of such country), or the United States, a State, the District of Columbia, or a political subdivision or local authority of a State;

(C) A corporation that is a resident of the foreign country of which the foreign corporation is a resident and whose stock is primarily and regularly traded on an established securities

market (within the meaning of paragraph (d) of this section) in that country or the United States or a domestic corporation whose stock is primarily and regularly traded on an established securities market (within the meaning of paragraph (d) of this section) in the United States;

(D) A not-for profit organization described in paragraph (b)(1)(iv) of this section that is not a pension fund as defined in paragraph (b)(8)(i)(A) of this section and that is organized under the laws of the foreign country of which the foreign corporation is a resident or the United States; or

(E) A beneficiary of certain pension funds (as defined in paragraph (b)(8)(i)(A) of this section) administered in or by the country in which the foreign corporation is a resident to the extent provided in paragraph (b)(8) of this section.

Beneficial owners of an association taxable as a corporation shall be treated as shareholders of such association for purposes of this paragraph (b)(1). If stock of a foreign corporation is owned by a corporation that is treated as a qualifying shareholder under paragraph (b)(1)(i)(C) of this section, such stock shall not also be treated as owned, directly or indirectly, by any qualifying shareholders of such corporation for purposes of this paragraph (b). Notwithstanding the above, a foreign corporation will not be treated as a qualified resident unless it obtains the documentation described in paragraph (b)(3) of this section to show that the requirements of this paragraph (b)(1)(i) have been met and maintains the documentation as provided in paragraph (b)(9) of this section. See also paragraph (b)(1)(iii) of this section, which treats certain publicly-traded classes of stock as owned by qualifying shareholders.

(ii) *Special rules relating to qualifying shareholders.* For purposes of applying paragraph (b)(1)(i) of this section—

(A) Stock owned on any day shall be taken into account only if the beneficial owner is a qualifying shareholder on that day or, in the case of a corporation or not-for-profit organization that is a qualifying shareholder under paragraph (b)(1)(i) (C) or (D) of this section, for a one-year period that includes such day; and

(B) An individual, corporation or not-for-profit organization is a resident of a foreign country if it is a resident of that country for purposes of the income tax treaty between the United States and that country.

(iii) *Publicly-traded class of stock treated as owned by qualifying shareholders.* A class of stock of a foreign corporation shall be treated as owned by qualifying shareholders if—

(A) The class of stock is listed on an established securities market in the United States or in the country of residence of the foreign corporation seeking qualified resident status; and

(B) The class of stock is primarily and regularly traded on such market (within the meaning of paragraphs (d)(3) and (4) of this section, applied as if the class of stock were the sole class of stock relied on to meet the requirements of paragraph (d)(4)(i)(A)).

For purposes of this paragraph (b), stock in such class shall not also be treated as owned by any qualifying shareholders who own such stock, either directly or indirectly.

(iv) *Special rule for not-for-profit organizations.* A not-for-profit organization is described in paragraph (b)(1)(iv) of this section if it meets the following requirements—

(A) It is a corporation, association taxable as a corporation, trust, fund, foundation, league or other entity operated exclusively for religious, charitable, educational, or recreational purposes, and it is not organized for profit;

(B) It is generally exempt from tax in its country of organization by virtue of its not-for-profit status; and

(C) Either—

(*1*) More than 50 percent of its annual support is expended on behalf of persons described in paragraphs (b)(1)(i)(A) through (E) of this section or on qualified residents of the country in which the organization is organized; or

(*2*) More than 50 percent of its annual support is derived from persons described in paragraphs (b)(1)(i) (A) through (E) of this section or from persons who are qualified residents of the country in which the organization is organized.

For purposes of meeting the requirements of paragraph (b)(1)(iv)(C) of this section, a not-for-profit organization may rely on the addresses of record of its individual beneficiaries and supporters to determine if such persons are resident in the country in which the not-for-profit organization is organized, provided that the addresses of record are not nonresidential addresses such as a post office box or in care of a financial intermediary, and the officers, directors or administrators of the organization do not know or have reason to know that the individual beneficiaries or supporters do not reside at that address.

(2) *Rules for determining constructive ownership*—(i) *General rules for attribution.* For purposes of this section, stock owned by a corporation, partnership, trust, estate, or mutual insurance company or similar entity shall be treated as owned proportionately by its shareholders, partners, beneficiaries, grantors or other interest holders as provided in paragraph (b)(2)(ii) through (v) of this section. The proportionate interest rules of this paragraph (b)(2) shall apply successively upward through a chain of ownership, and a person's proportionate interest shall be computed for the relevant days or period that is taken into account in determining whether a foreign corporation is a qualified resident. Except as otherwise provided, stock treated as owned by a person by reason of this paragraph (b)(2) shall, for purposes of applying this paragraph (b)(2), be treated as actually owned by such person.

(ii) *Partnerships.* A partner shall be treated as having an interest in stock of a foreign corporation owned by a partnership in proportion to the least of—

(A) The partner's percentage distributive share of the partnership's dividend income from the stock;

(B) The partner's percentage distributive share of gain from disposition of the stock by the partnership;

(C) The partner's percentage distributive share of the stock (or proceeds from the disposition of the stock) upon liquidation of the partnership.

For purposes of this paragraph (b)(2)(ii), however, all qualifying shareholders that are partners of a partnership shall be treated as one partner. Thus, the percentage distributive shares of dividend income, gain and liquidation rights of all qualifying shareholders that are partners in a partnership are aggregated prior to determining the least of the three percentages.

(iii) *Trusts and estates*—(A) *Beneficiaries.* In general, a person shall be treated as having an interest in stock of a foreign corporation owned by a trust or estate in proportion to the person's actuarial interest in the trust or estate, as provided in section 318(a)(2)(B)(i), except that an income beneficiary's actuarial interest in the trust will be determined as if the trust's only asset were the stock. The interest of a remainder beneficiary in stock will be equal to 100 percent minus the sum of the percentages of any interest in the stock held by income beneficiaries. The ownership of an interest in stock owned by a trust shall not be attributed to any beneficiary whose interest cannot be determined under the preceding sentence, and any such interest, to the extent not attributed by reason of this paragraph (b)(2)(iii)(A), shall not be considered owned by a beneficiary unless all potential beneficiaries with respect to the stock are qualifying shareholders. In addition, a beneficiary's actuarial interest will be treated as zero to extent that a grantor is treated as owning the stock under paragraph (b)(2)(iii)(B) of this section. A substantially separate and independent share of a trust, within the meaning of section 663(c), shall be treated as a separate trust for purposes of this paragraph (b)(2)(iii)(A), provided that payment of income, accumulated income or corpus of a share of one beneficiary (or group of beneficiaries) cannot affect the proportionate share of income, accumulated income or corpus of another beneficiary (or group of beneficiaries).

(B) *Grantor trusts.* A person is treated as the owner of stock of a foreign corporation owned by a trust to the extent that the stock is included in the portion of the trust that is treated as owned by the person under sections 671 to 679 (relating to grantors and others treated as substantial owners).

(iv) *Corporations that issue stock.* A shareholder of a corporation that issues stock shall be treated as owning stock of a foreign corporation that is owned by such corporation on any day in a proportion that equals the value of the stock owned by such shareholder to the value of all stock of such corporation. If there is an agreement, express or implied, that a shareholder of a corporation will not receive distributions from the earnings of stock owned by the corporation, the shareholder will not be treated as owning that stock owned by the corporation.

(v) *Mutual insurance companies and similar entities.* Stock held by a mutual insurance company, mutual savings bank, or similar entity (including an association taxable as a corporation that does not issue stock interests) shall be considered owned proportionately by the policy holders, depositors, or other owners in the same proportion that such persons share in the surplus of such entity upon liquidation or dissolution.

(vi) *Pension funds.* See paragraphs (b)(8) (ii) and (iii) of this section for the attribution of stock owned by a pension fund (as defined in paragraph (b)(8)(i)(A)) to beneficiaries of the fund.

(vii) *Examples.* The rules of paragraph (b)(2)(ii) of this section are illustrated by the following examples.

Example 1. Stock held solely by qualifying shareholders through a partnership. A and B, residents of country X, are qualifying shareholders, within the meaning of paragraphs (b)(1)(i) (A) through (E) of this section, and the sole partners of partnership P. P's only asset is the stock of foreign corporation Z, a country X corporation seeking qualified resident status under this section. A's distributive share of P's income and gain on the disposition of P's assets is 80 percent, but A's distributive share of P's assets (or the proceeds therefrom) on P's liquidation is 20 percent. B's distributive share of P's income and gain is 20 percent and B is entitled to 80 percent of the assets (or proceeds therefrom) on P's liquidation. Under the attribution rules of paragraph (b)(2)(ii) of this section, A and B will be treated as a single partner owning in the aggregate 100 percent of the stock of Z owned by P.

Example 2. Stock held by both qualifying and non-qualifying shareholders through a partnership. Assume the same facts as in *Example 1* except that C, an individual who is not a qualifying shareholder, is also a partner in P and that C's distributive share of P's income is 60 percent. The distributive shares of A and B are the same as in *Example 1* except that A's distributive share of income is 20 percent. Under the attribution rules of paragraph (b)(2)(ii) of this section, A and B will be treated as a single partner owning in the aggregate 40 percent of the stock of Z owned by P (i.e., the least of A and B's aggregate distributive shares of dividend income (40 percent), gain (100 percent), and liquidation rights (100 percent) with respect to the Z stock).

Example 3. Stock held through tiered partnerships. Assume the same facts as in *Example 1,* except that P does not own the stock of Z directly, but rather is a partner in partnership P1, which owns the stock of Z. Assume that P's distributive share of the dividend income, gain and liquidation rights with respect to the Z stock held by P1 is 40 percent. Assume that of the remaining partners of P1 only D is a qualifying shareholder. D's distributive share of P1's dividend income and gain is 15 percent; D's distributive share of P1's assets on liquidation is 25 percent. Under the attribution rules of paragraph (b)(2)(ii) of this section, A and B, treated as a single partner, will own 40 percent of the Z stock owned by P1 (100 percent X 40 percent) and D will be treated as owning 15 percent of the Z stock owned by P1 (the least of D's dividend income (15 percent), gain (15 percent), and liquidation rights (25 percent) with respect to the Z stock). Thus, 55 percent of the Z stock owned by P1 is treated as owned by qualifying shareholders under paragraph (b)(2)(ii) of this section.

(3) *Required documentation*—(i) *Ownership statements, certificates of residency and intermediary ownership statements.* Except as provided in paragraphs (b)(3)(ii), (iii) and (iv) and paragraph (b)(8) of this section, a person shall only be treated as a qualifying shareholder of a foreign corporation if—

(A) For the relevant period, the person completes an ownership statement described in paragraph (b)(4) of this section and, in the case of an individual who is not a U.S. citizen or resident, also obtains a certificate of residency described in paragraph (b)(5) of this section;

(B) In the case of a person owning stock in the foreign corporation indirectly through one or more intermediaries (including mere legal owners or recordholders acting as nominees), each intermediary completes an intermediary ownership statement described in paragraph (b)(6) of this section; and

(C) Such ownership statements and certificates of residency are received by the foreign corporation on or before the earlier of the date it files its income tax return for the taxable year to which the statements relate or the due date (including extensions) for filing such return or, in the case of a foreign corporation claiming treaty benefits under §1.884–4(b)(8) (i) or (ii) (relating to branch interest) on or before the date on which such interest is paid.

(ii) *Substitution of intermediary verification statement for ownership statements and certificates of residency.* If a qualifying shareholder owns stock through an intermediary that is either a domestic corporation, a resident of the United States, or a resident (for treaty purposes) of a country with which the United States has an income tax treaty in effect, the intermediary may provide an intermediary verification statement (as described in paragraph (b)(7) of this section) in place of any relevant ownership statements and certificates of residency from qualifying shareholders, and in place of intermediary ownership statements (or, where applicable, intermediary verification statements) from all intermediaries standing in the chain of ownership between the qualifying shareholders and the intermediary issuing the intermediary verification statement. An intermediary verification statement generally certifies that the verifying intermediary holds the documentation described in the preceding sentence and agrees to make it available to the District Director on request. Such intermediary verification statements, along with an intermediary ownership statement from the verifying intermediary, must be received by the foreign corporation on or before the earlier of the date if files its income tax return for the taxable year to which the statements relate or the due date (including extensions) for filing such return. An indirect owner of a foreign corporation is thus treated as a qualifying shareholder of a foreign corporation if the foreign corporation receives, on or before the time specified above, an intermediary verification statement and an intermediary ownership statement from the verifying intermediary and an intermediary ownership statement from all intermediaries standing in the chain of the verifying intermediary's ownership of its interest in the foreign corporation.

(iii) *Special rule for registered shareholders of widely-held corporations.* An ownership statement and a certificate of residency shall not be required in the case of an individual who is a shareholder of record of a corporation that has at least 250 shareholders if—

(A) The individual owns less than one percent of the stock (by value) (applying the attribution rules of section 318) of the corporation at all times during the taxable year;

(B) The individual's address of record is in the corporation's country of residence and is not a nonresidential address such as a post office box or in care of a financial intermediary or stock transfer agent; and

(C) The officers and directors of the corporation do not know or have reason to know that the individual does not reside at that address.

The rule in this paragraph (b)(3)(iii) may also be applied with respect to individual owners of mutual insurance companies, mutual savings banks or similar entities, provided that the same conditions set forth in this paragraph (b)(3)(iii) are met with respect to such individuals.

(iv) *Special rule for pension funds.* See paragraphs (b)(8) (ii) through (v) of this section for special documentation rules applicable to pension funds (as defined in paragraph (b)(8)(i)(A) of this section).

(v) *Reasonable cause exception.* If a foreign corporation does not obtain the documentation described in this paragraph (b)(3) or (b)(8) of this section in a timely manner but is able to show prior to notification of an examination of the return for the taxable year that the failure was due to reasonable cause and not willful neglect, the foreign corporation may perfect the documentation after the deadlines specified in this paragraph (b)(3) or (b)(8) of this section. It may make such a showing by providing a written statement to the District Director having jurisdiction over the taxpayer's return or the Office of the Assistant Commissioner (International), as applicable, setting

forth the reasons for the failure to obtain the documentation in a timely manner and describing the documentation that was received after the deadline had passed. Whether a failure to obtain the documentation in a timely manner was due to reasonable cause shall be determined by the District Director or the Office of the Assistant Commissioner (International), as applicable, under all the facts and circumstances.

(4) *Ownership statements from qualifying shareholders*—(i) *Ownership statements from individuals.* An ownership statement from an individual is a written statement signed by the individual under penalties of perjury stating—

(A) The name, permanent address, and country of residence of the individual and, if the individual was not a resident of the country for the entire taxable year of the foreign corporation seeking qualified resident status, the period during which it was a resident of the foreign corporation's country of residence;

(B) If the individual is a direct beneficial owner of stock in the foreign corporation, the name of the corporation, the number of shares in each class of stock of the corporation that are so owned, and the period of time during the taxable year of the foreign corporation during which the individual owned the stock (or, in the case of an association taxable as a corporation, the amount and nature of the owner's interest in such association);

(C) If the individual directly owns an interest in a corporation, partnership, trust, estate or other intermediary that owns (directly or indirectly) stock in the foreign corporation, the name of the intermediary, the number and class of shares or amount and nature of the interest of the individual in such intermediary (that is relevant for purposes of attributing ownership in paragraph (b)(2) of this section), and the period of time during the taxable year of the foreign corporation during which the individual held such interest; and

(D) To the extent known by the individual, a description of the chain of ownership through which the individual owns stock in the foreign corporation, including the name and address of each intermediary standing between the intermediary described in paragraph (b)(4)(i)(C) of this section and the foreign corporation.

(ii) *Ownership statements from governments.* An ownership statement from a government that is a qualifying shareholder is a written statement signed by either—

(A) An official of the governmental authority, agency or office that has supervisory authority with respect to the government's ownership interest who is authorized to sign such a statement on behalf of the authority, agency or office; or

(B) The competent authority of the foreign country (as defined in the income tax treaty between the United States and the foreign country).

Such statement shall provide the title of the official signing the statement and the name and address of the government agency, and shall provide the information described in paragraphs (b)(4)(i) (B) through (D) of this section (substituting ''government'' for ''individual'') with respect to the government's direct or indirect ownership of stock in the foreign corporation seeking qualified resident status.

(iii) *Ownership statements from publicly-traded corporations.* An ownership statement from a corporation that is a qualifying shareholder under paragraph (b)(1)(i)(C) of this section is a written statement signed by a person authorized to sign a tax return on behalf of the corporation under penalties of perjury stating—

(A) The name, permanent address, and principal place of business of the corporation (if different from its permanent address);

(B) The information described in paragraphs (b)(4)(i) (B) through (D) of this section (substituting ''corporation'' for ''individual''); and

(C) That the corporation's stock is primarily and regularly traded on an established securities exchange (within the meaning of paragraph (d) of this section) in the United States or its country of residence.

(iv) *Ownership statements from not-for-profit organizations.* An ownership statement from a not-for-profit organization (other than a pension fund as defined in paragraph (b)(8)(i)(A) of this section) is a written statement signed

by a person authorized to sign a tax return on behalf of the organization under penalties of perjury stating—

(A) The name, permanent address, and principal location of the activities of the organization (if different from its permanent address);

(B) The information described in paragraphs (b)(4)(i) (B) through (D) of this section (substituting ''not-for-profit organization'' for ''individual'') with respect to the not-for-profit organization's direct or indirect ownership of stock in the foreign corporation seeking qualified resident status; and

(C) That the not-for-profit organization satisfies the requirements of paragraph (b)(1)(iv) of this section.

(v) *Ownership through a nominee.* For purposes of this paragraph (b)(4) and paragraph (b)(6) of this section, a person who owns either stock in a foreign corporation seeking qualified resident status or an interest in an intermediary described in paragraph (b)(4)(i)(C) of this section through a nominee shall be treated as owning such stock or interest directly and must, therefore, provide the information described in paragraphs (b)(4) (i) through (iv) of this section, as applicable. Such person must also provide the name and address of the nominee.

(5) *Certificate of residency.* A certificate of residency must be signed by the relevant authorities (as described below) of the country of residence of the individual shareholder and must state that the individual is a resident of that country for purposes of its income tax laws or, if the authorities do not customarily make such a determination, that the individual has filed a tax return claiming resident status and subjecting the individual's income to tax on a resident basis for the taxable year or period that ends with or within the taxable year for which the corporation is seeking qualified resident status. In the case of an individual who is not legally required to file a tax return in his or her country of residence or in any other country, a certificate of residency of a parent or guardian residing at such individual's address shall be considered sufficient to meet that individual's obligation under this paragraph (b)(5). The relevant authorities shall be the competent authority of the foreign country of which the foreign corporation is a resident, as defined in the income tax treaty between the foreign country and the United States, or such other governmental office of the foreign country (or political subdivision thereof) that customarily provides statements of residence. Notwithstanding the foregoing, the Commissioner may consult with the competent authority of a country regarding the procedures set forth in this paragraph (b)(5) and if necessary agree on additional or alternative procedures under which these certificates may be issued.

(6) *Intermediary ownership statement.* An intermediary ownership statement is a written statement signed under penalties of perjury by the intermediary (if the intermediary is an individual) or a person that would be authorized to sign a tax return on behalf of the intermediary (if the intermediary is not an individual) containing the following information:

(i) The name, address, country of residence, and principal place of business (in the case of a corporation or partnership) of the intermediary and, if the intermediary is a trust or estate, the name and permanent address of all trustees or executors (or equivalent under foreign law);

(ii) The information described in paragraphs (b)(4)(i) (B) through (D) (substituting ''intermediary making the ownership statement'' for ''individual'') with respect to the intermediary's direct or indirect ownership in the stock in the foreign corporation seeking qualified resident status;

(iii) If the intermediary is a nominee for a qualifying shareholder or another intermediary, the name and permanent address of the qualifying shareholder, or the name and principal place of business of such other intermediary;

(iv) If the intermediary is not a nominee for a qualifying shareholder or another intermediary, the proportionate interest in the intermediary of each direct shareholder, partner, beneficiary, grantor, or other interest holder (or if the direct holder is a nominee, of its beneficial shareholder, partner, beneficiary, grantor, or other interest holder) from which the intermediary

received an ownership statement and the period of time during the taxable year for which the interest in the intermediary was owned by such shareholder, partner, beneficiary, grantor or other interest holder. For purposes of this paragraph (b)(6)(iv), the proportionate interest of a person in an intermediary is the percentage interest (by value) held by such person, determined using the principles for attributing ownership in paragraph (b)(2) of this section. If an intermediary is not required to receive an ownership statement from its individual registered shareholders or other interest holders by reason of paragraph (b)(3)(iii) of this section, then it must provide a list of the names and addresses of such registered shareholders or other interest holders and the aggregate proportionate interest in the intermediary of such registered shareholders or other interest holders.

(7) *Intermediary verification statement.* An intermediary verification statement that may be substituted for certain documentation under paragraph (b)(3)(ii) of this section is a written statement signed under penalties of perjury by the intermediary (if the intermediary is an individual) or by a person that would be authorized to sign a tax return on behalf of the intermediary (if the verifying intermediary is not an individual) containing the following information—

(i) The name, principal place of business, and country of residence of the verifying intermediary;

(ii) A statement that the verifying intermediary has obtained either—

(A) An ownership statement and, if applicable, a certificate of residency from a qualifying shareholder with respect to the foreign corporation seeking qualified resident status, and an intermediary ownership statement from each intermediary standing in the chain of ownership between the verifying intermediary and the qualifying shareholder; or

(B) An intermediary verification statement substituting for the documentation described in paragraph (b)(7)(ii)(A) and an intermediary ownership statement from such intermediary and each intermediary standing in the chain of ownership between such intermediary and the verifying intermediary;

(iii) The proportionate interest (as computed using the documentation described in paragraph (b)(7)(ii) of this section) in the intermediary owned directly or indirectly by qualifying shareholders;

(iv) An agreement to make available to the Commissioner at such time and place as the Commissioner may request the underlying documentation described in paragraph (b)(7)(ii) of this section; and

(v) A specific and valid waiver of any right to bank secrecy or other secrecy under the laws of the country in which the verifying intermediary is located, with respect to any qualifying shareholder ownership statements, certificates of residency, intermediary ownership statements or intermediary verification statements that the verifying intermediary has obtained pursuant to paragraph (b)(7)(ii) of this section.

A foreign corporation may combine, in a single statement, the information in an intermediary ownership statement and the information in an intermediary verification statement.

(8) *Special rules for pension funds*—(i) *Definitions*—(A) *Pension fund.* For purposes of this section, the term ''pension fund'' shall mean a trust, fund, foundation, or other entity that is established exclusively for the benefit of employees or former employees of one or more employers, the principal purpose of which is to provide retirement, disability, and death benefits to beneficiaries of such entity and persons designated by such beneficiaries in consideration for prior services rendered.

(B) *Beneficiary.* For purposes of this section, the term ''beneficiary'' of a pension fund shall mean any person who has made contributions to the pension fund, or on whose behalf contributions have been made, and who is currently receiving retirement, disability, or death benefits from the pension fund or can reasonably be expected to receive such benefits in the future, whether or not the person's right to receive benefits from the fund has vested.

(ii) *Government pension funds.* An individual who is a beneficiary of a pension fund that would be a controlled

entity of a foreign sovereign within the principles of § 1.892–2T(c)(1) of the regulations (relating to pension funds established for the benefit of employees or former employees of a foreign government) shall be treated as a qualifying shareholder of a foreign corporation in which the pension fund owns a direct or indirect interest without having to meet the documentation requirements under paragraph (b)(3)(i)(A) of this section, if the foreign corporation is resident in the country of the foreign sovereign and the trustees, directors, or other administrators of the pension fund provide, with the pension fund's intermediary ownership statement described in paragraph (b)(6) of this section, a written statement that the fund is a controlled entity described in this paragraphs (b)(8)(ii). See paragraph (b)(4)(ii) of this section regarding an ownership statement from a pension fund that is an integral part of a foreign government.

(iii) *Non-government pension funds.* For purposes of this section, an individual who is a beneficiary of a pension fund not described in paragraph (b)(8)(ii) of this section shall be treated as a qualifying shareholder of a foreign corporation owned directly or indirectly by such pension fund without having to meet the documentation requirements under paragraph (b)(3)(i)(A) of this section, if—

(A) The pension fund is administered in the foreign corporation's country of residence and is subject to supervision or regulation by a governmental authority (or other authority delegated to perform such supervision or regulation by a governmental authority) in such country;

(B) The pension fund is generally exempt from income taxation in its country of administration;

(C) The pension fund has 100 or more beneficiaries;

(D) The beneficiary's address, as it appears on the records of the fund, is in the foreign corporation's country of residence or the United States and is not a nonresidential address, such as a post office box or in care of a financial intermediary, and none of the trustees, directors or other administrators of the pension fund know, or have reason to know, that the beneficiary is not an individual resident of such foreign country or the United States;

(E) In the case of a pension fund that has fewer than 500 beneficiaries, the beneficiary's employer provides (if the beneficiary is currently contributing to the fund) to the trustees, directors or other administrators a written statement that the beneficiary is currently employed in the country in which the fund is administered or is usually employed in such country but is temporarily employed by the company outside of the country; and

(F) The trustees, directors or other administrators of the pension fund provide, with the pension fund's intermediary ownership statement described in paragraph (b)(6) of this section, a written statement signed under penalties of perjury declaring that the pension fund meets the requirements in paragraphs (b)(8)(iii) (A), (B), and (C) of this section and giving the number of beneficiaries who meet the requirements of paragraph (b)(8)(iii)(D) of this section, and, if applicable, paragraph (b)(8)(iii)(E) of this section.

(iv) *Computation of beneficial interests in non-government pension funds.* The number of shares in a foreign corporation that are held indirectly by beneficiaries of a pension fund who are qualifying shareholders may be computed based on the ratio of the number of such beneficiaries to all beneficiaries of the pension fund (rather than on the basis of the rules in paragraph (b)(2) of this section) if—

(A) The pension fund meets the requirements of paragraphs (b)(8)(iii) (A), (B), and (C) of this section;

(B) The trustees, directors or other administrators of the pension fund have no knowledge, and no reason to know, that the ratio of the pension fund's beneficiaries who are residents of either the country in which the pension fund is administered or of the United States to all beneficiaries of the pension fund would differ significantly from the ratio of the sum of the actuarial interests of such residents in the pension fund to the actuarial interests of all beneficiaries in the pension fund (or, if the beneficiaries' actuarial interest in the stock held directly or indirectly by the pension fund differs from the beneficiaries' actuarial interest in

the pension fund, the ratio of actuarial interests computed by reference to the beneficiaries' actuarial interest in the stock);

(C) Either—

(*1*) Any overfunding of the pension fund would be payable, pursuant to the governing instrument or the laws of the foreign country in which the pension fund is administered, only to, or for the benefit of, one or more corporations that are qualified residents of the country in which the pension fund is administered, individual beneficiaries of the pension fund or their designated beneficiaries, or social or charitable causes (the reduction of the obligation of the sponsoring company or companies to make future contributions to the pension fund by reason of overfunding shall not itself result in such overfunding being deemed to be payable to or for the benefit of such company or companies); or

(*2*) The foreign country in which the pension fund is administered has laws that are designed to prevent overfunding of a pension fund and the funding of the pension fund is within the guidelines of such laws; or

(*3*) The pension fund is maintained to provide benefits to employees in a particular industry, profession, or group of industries or professions and employees of at least 10 companies (other than companies that are owned or controlled, directly or indirectly, by the same interests) contribute to the pension fund or receive benefits from the pension fund; and

(D) The trustees, directors or other administrators provide, with the pension fund's intermediary ownership statement described in paragraph (b)(6) of this section, a written statement signed under penalties of perjury certifying that the requirements in paragraphs (b)(8)(iv) (A), (B), and either (C)(*1*), (C)(*2*) or (C)(*3*) of this section have been met.

The statement described in paragraph (b)(8)(iv) (D) of this section may be combined, in a single statement, with the information required in paragraph (b)(8)(iv) (F) of this section.

(v) *Time for making determinations.* The determinations required to be made under this paragraph (b)(8) shall be made using information shown on the records of the pension fund for a date on or after the beginning of the foreign corporation's taxable year to which the determination is relevant.

(9) *Availability of documents for inspection*—(i) *Retention of documents by the foreign corporation.* The documentation described in paragraphs (b)(3) and (b)(8) of this section must be retained by the foreign corporation until expiration of the period of limitations for the taxable year to which the documentation relates and must be made available for inspection by the District Director at such time and place as the District Director may request.

(ii) *Retention of documents by an intermediary issuing an intermediary verification statement.* The documentation upon which an intermediary relies to issue an intermediary verification statement under paragraph (b)(7) of this section must be retained by the intermediary for a period of six years from the date of issuance of the intermediary verification statement and must be made available for inspection by the District Director at such time and place as the District Director may request.

(10) *Examples.* The application of this paragraph (b) is illustrated by the following examples.

Example 1. Foreign corporation A is a resident of country L, which has an income tax treaty in effect with the United States. Foreign corporation A has one class of stock issued and outstanding consisting of 1,000 shares, which are beneficially owned by the following alien individuals, directly or by application of paragraph (b)(2) of this section:

Individual	Shares owned, directly or indirectly by application of paragraph (b)(2) of this section	Percentage
T—resident of the U.S	200	20
U—resident of country L	400	40
V—resident of country M	100	10
W—resident of country L	210	21
X—resident of country N	90	9
Total	1,000	100

(i) T owns his 200 shares directly and is a beneficial owner.

(ii) U and V own, respectively, an 80 percent and a 20 percent actuarial interest in

foreign trust FT, (which interest does not differ from their respective interests in the stock owned by FT), which beneficially owns 100 percent of the stock of a foreign corporation B with bearer shares, which beneficially owns 500 shares of foreign corporation A. Foreign corporation B is incorporated in a country that does not have an income tax treaty with the United States. The foreign trust has deposited the bearer shares it owns in B with a bank in a foreign country that has an income tax treaty with the United States.

(iii) W beneficially owns all the shares of foreign corporation C, which are registered in the name of individual Z, a nominee, who resides in country L; foreign corporation C beneficially owns a 70 percent interest in foreign corporation D, which beneficially owns 300 shares of A. D's shares are bearer shares that C (not a resident of a country with which the United States has an income tax treaty) has deposited with a bank in a foreign country that has an income tax treaty with the United States.

(iv) X beneficially owns a 30 percent interest in foreign corporation D.

(v) A is a qualified resident of country L if it obtains the applicable documentation described in paragraph (b)(3) of this section either with respect to ownership by individuals U and W or with respect to ownership by individuals T and U, since either combination of qualifying shareholders of foreign corporation A will exceed 50 percent.

Example 2. Assume the same facts as in *Example 1* and assume that foreign corporation A chooses to obtain documentation with respect to individuals T and U.

(i) A must obtain, pursuant to paragraph (b)(3)(i) of this section, an ownership statement (as described in paragraph (b)(4)(i) of this section) signed by T. T is not required to furnish a certificate of residency because T is a U.S. resident.

(ii) U must provide foreign trust FT with an ownership statement and certificate of residency, as described in paragraphs (b)(4) and (b)(5) of this section. The trustees of FT must provide the depository bank holding foreign corporation B's bearer shares with an intermediary ownership statement concerning its beneficial ownership of B's shares and must attach to it the documentation provided by U. The depository bank must provide B with an intermediary ownership statement regarding its holding of B shares on behalf of FT and has the choice of attaching—

(A) The documentation from U and the intermediary ownership statement from FT; or

(B) An intermediary verification statement described in paragraph (b)(7) of this section, in which case foreign corporation B would not be provided with U's individual documentation or FT's intermediary ownership statement, both of which are retained by the depository bank.

(iii) In either case, B must then provide foreign corporation A with an intermediary ownership statement regarding its direct beneficial ownership of shares in A and, as the case may be, either—

(A) U's documentation and the intermediary ownership statements by FT and the depository bank; or

(B) The depository bank's intermediary ownership and verification statements.

(iv) Thus, with respect to U, A must obtain under paragraph (b)(3)(i) of this section the individual documentation regarding U and an intermediary ownership statement from each intermediary standing in the chain of U's indirect beneficial ownership of shares in A, i.e., from FT, the depository bank and B. In the alternative, A must obtain under paragraph (b)(3)(ii) of this section an intermediary verification statement issued by the depository bank and an intermediary ownership statement from the bank and from B, which, in this example, are the only intermediaries standing in the chain of ownership of the verifying intermediary (i.e., the depository bank).

Example 3. Assume the same facts as in *Example 1.* In addition, assume that foreign corporation A chooses to obtain documentation with respect to individuals U and W. With respect to U, A must obtain the same documentation that is described in *Example 2.* With respect to W, A must obtain, under paragraph (b)(3)(i) of this section, individual documentation regarding W and an intermediary ownership statement from each intermediary standing in the chain of W's indirect beneficial ownership of shares in A, i.e., from individual Z, foreign corporation C, the depository bank in the foreign treaty country, and foreign corporation D. In the alternative, A must obtain, under paragraph (b)(3)(ii) of this section, either—

(i) An intermediary verification statement by the depository bank in the foreign treaty country and an intermediary ownership statement from the bank and from D; or

(ii) An intermediary verification statement from Z and an intermediary ownership statement from Z and from each intermediary standing in the chain of ownership of shares in foreign corporation A, i.e., from C, the depository bank in the foreign treaty country and D. C may not issue an intermediary verification statement because it is not a resident of a country with which the United States has an income tax treaty.

(c) *Base erosion.* A foreign corporation satisfies the requirement relating to base erosion for a taxable year if it establishes that less than 50 percent of its income for the taxable year is used

(directly or indirectly) to make deductible payments in the current taxable year to persons who are not residents (or, in the case of foreign corporations, qualified residents) of the foreign country of which the foreign corporation is a resident and who are not citizens or residents (or, in the case of domestic corporations, qualified residents) of the United States. Whether a domestic corporation is a qualified resident of the United States shall be determined under the principles of this section. For purposes of this paragraph (c), the term ''deductible payments'' includes payments that would be ordinarily deductible under U.S. income tax principles without regard to other provisions of the Code that may require the capitalization of the expense, or disallow or defer the deduction. Such payments include, for example, interest, rents, royalties and reinsurance premiums. For purposes of this paragraph (c), the income of a foreign corporation means the corporation's gross income for the taxable year (or, if the foreign corporation has no gross income for the taxable year, the average of its gross income for the three previous taxable years) under U.S. tax principles, but not excluding items of income otherwise excluded from gross income under U.S. tax principles.

(d) *Publicly-traded corporations*—(1) *General rule.* A foreign corporation that is a resident of a foreign country shall be treated as a qualified resident of that country for any taxable year in which—

(i) Its stock is primarily and regularly traded (as defined in paragraphs (d) (3) and (4) of this section) on one or more established securities markets (as defined in paragraph (d)(2) of this section) in that country, or in the United States, or both; or

(ii) At least 90 percent of the total combined voting power of all classes of stock of such foreign corporation entitled to vote and at least 90 percent of the total value of the stock of such foreign corporation is owned, directly or by application of paragraph (b)(2) of this section, by a foreign corporation that is a resident of the same foreign country or a domestic corporation and the stock of such parent corporation is primarily and regularly traded on an established securities market in that foreign country or in the United States, or both.

(2) *Established securities market*—(i) *General rule.* For purposes of section 884, the term ''established securities market'' means, for any taxable year—

(A) A foreign securities exchange that is officially recognized, sanctioned, or supervised by a governmental authority of the country in which the market is located, is the principal exchange in that country, and has an annual value of shares traded on the exchange exceeding $1 billion during each of the three calendar years immediately preceding the beginning of the taxable year;

(B) A national securities exchange that is registered under section 6 of the Securities Act of 1934 (15 U.S.C. 78f); and

(C) A domestic over-the-counter market (as defined in paragraph (d)(2)(iv) of this section).

(ii) *Exchanges with multiple tiers.* If a principal exchange in a foreign country has more than one tier or market level on which stock may be separately listed or traded, each such tier shall be treated as a separate exchange.

(iii) *Computation of dollar value of stock traded.* For purposes of paragraph (d)(2)(i)(A) of this section, the value in U.S. dollars of shares traded during a calendar year shall be determined on the basis of the dollar value of such shares traded as reported by the International Federation of Stock Exchanges, located in Paris, or, if not so reported, then by converting into U.S. dollars the aggregate value in local currency of the shares traded using an exchange rate equal to the average of the spot rates on the last day of each month of the calendar year.

(iv) *Definition of over-the-counter market.* An over-the-counter market is any market reflected by the existence of an interdealer quotation system. An interdealer quotation system is any system of general circulation to brokers and dealers that regularly disseminates quotations of stocks and securities by identified brokers or dealers, other than by quotation sheets that are prepared and distributed by a broker or dealer in the regular course of business

and that contain only quotations of such broker or dealer.

(v) *Discretion to determine that an exchange qualifies as an established securities market.* The Commissioner may, in his sole discretion, determine in a published document that a securities exchange that does not meet the requirements of paragraph (d)(2)(i)(A) of this section qualifies as an established securities market. Such a determination will be made only if it is established that—

(A) The exchange, in substance, has the attributes of an established securities market (including adequate trading volume, and comparable listing and financial disclosure requirements);

(B) The rules of the exchange ensure active trading of listed stocks; and

(C) The exchange is a member of the International Federation of Stock Exchanges.

(vi) *Discretion to determine that an exchange does not qualify as an established securities market.* The Commissioner may, in his sole discretion, determine in a published document that a securities exchange that meets the requirements of paragraph (d)(2)(i) of this section does not qualify as an established securities market. Such determination shall be made if, in the view of the Commissioner—

(A) The exchange does not have adequate listing, financial disclosure, or trading requirements (or does not adequately enforce such requirements); or

(B) There is not clear and convincing evidence that the exchange ensures the active trading of listed stocks.

(3) *Primarily traded.* For purposes of this section, stock of a corporation is ''primarily traded'' on one or more established securities markets in the corporation's country of residence or in the United States in any taxable year if, with respect to each class described in paragraph (d)(4)(l)(i)(A) of this section (relating to classes of stock relied on to meet the regularly traded test)—

(i) The number of shares in each class that are traded during the taxable year on all established securities markets in the corporation's country of residence or in the United States during the taxable year exceeds

(ii) The number of shares in each such class that are traded during that year on established securities markets in any other single foreign country.

(4) *Regularly traded*—(i) *General rule.* For purposes of this section, stock of a corporation is ''regularly traded'' on one or more established securities markets in the foreign corporation's country of residence or in the United States for the taxable year if—

(A) One or more classes of stock of the corporation that, in the aggregate, represent 80 percent or more of the total combined voting power of all classes of stock of such corporation entitled to vote and of the total value of the stock of such corporation are listed on such market or markets during the taxable year;

(B) With respect to each class relied on to meet the 80 percent requirement of paragraph (d)(4)(i)(A) of this section—

(*1*) Trades in each such class are effected, other than in *de minimis* quantities, on such market or markets on at least 60 days during the taxable year (or ⅙ of the number of days in a short taxable year); and

(*2*) The aggregate number of shares in each such class that is traded on such market or markets during the taxable year is at least 10 percent of the average number of shares outstanding in that class during the taxable year (or, in the case of a short taxable year, a percentage that equals at least 10 percent of the number of days in the short taxable year divided by 365).

If stock of a foreign corporation fails the 80 percent requirement of paragraph (d)(4)(i)(A) of this section, but a class of such stock meets the trading requirements of paragraph (d)(4)(i)(B) of this section, such class of stock may be taken into account under paragraph (b)(1)(iii) of this section as owned by qualifying shareholders for purposes of meeting the ownership test of paragraph (b)(1) of this section.

(ii) *Classes of stock traded on a domestic established securities market treated as meeting trading requirements.* A class of stock that is traded during the taxable year on an established securities market located in the United States shall be treated as meeting the trading requirements of paragraph (d)(4)(i)(B) of this section if the stock is regularly quoted by brokers or dealers making a

market in the stock. A broker or dealer makes a market in a stock only if the broker or dealer holds himself out to buy or sell the stock at the quoted price.

(iii) *Closely-held classes of stock not treated as meeting trading requirement*—(A) *General rule.* A class of stock shall not be treated as meeting the trading requirements of paragraph (d)(4)(i)(B) of this section (or the requirements of paragraph (d)(4)(ii) of this section) for a taxable year if, at any time during the taxable year, one or more persons who are not qualifying shareholders (as defined in paragraph (b)(1) of this section) and who each beneficially own 5 percent or more of the value of the outstanding shares of the class of stock own, in the aggregate, 50 percent or more of the outstanding shares of the class of stock for more than 30 days during the taxable year. For purposes of the preceding sentence, shares shall not be treated as owned by a qualifying shareholder unless such shareholder provides to the foreign corporation, by the time prescribed in paragraph (b)(3) of this section, the documentation described in paragraph (b)(3) of this section necessary to establish that it is a qualifying shareholder. For purposes of this paragraph (d)(4)(iii)(A), shares of stock owned by a pension fund, as defined in paragraph (b)(8)(i)(A) of this section, shall be treated as beneficially owned by the beneficiaries of such fund, as defined in paragraph (b)(8)(i)(B) of this section.

(B) *Treatment of related persons.* Persons related within the meaning of section 267(b) shall be treated as one person for purposes of this paragraph (d)(4)(iii). In determining whether two or more corporations are members of the same controlled group under section 267(b)(3), a person is considered to own stock owned directly by such person, stock owned with the application of section 1563(e)(1), and stock owned with the application of section 267(c). Further, in determining whether a corporation is related to a partnership under section 267(b)(10), a person is considered to own the partnership interest owned directly by such person and the partnership interest owned with the application of section 267(e)(3).

(iv) *Anti-abuse rule.* Trades between persons described in section 267(b) (as modified in paragraph (d)(4)(iii)(B) of this section) and trades conducted in order to meet the requirements of paragraph (d)(4)(i)(B) of this section shall be disregarded. A class of stock shall not be treated as meeting the trading requirements of paragraph (d)(4)(i)(B) of this section if there is a pattern of trades conducted to meet the requirements of that paragraph. For example, trades between two persons that occur several times during the taxable year my be treated as an arrangement or a pattern of trades conducted to meet the trading requirements of paragraph (d)(4)(i)(B) of this section.

(5) *Burden of proof for publicly-traded corporations.* A foreign corporation that relies on this paragraph (d) to establish that it is a qualified resident of a country with which the United States has an income tax treaty shall have the burden of proving all the facts necessary for the corporation to be treated as a qualified resident, except that with respect to paragraphs (d)(4) (iii) and (iv) of this section, a foreign corporation, with either registered or bearer shares, will meet the burden of proof if it has no reason to know and no actual knowledge of facts that would cause the corporation's stock not to be treated as regularly traded under such paragraphs. A foreign corporation that has shareholders of record must also maintain a list of such shareholders and, on request, make available to the District Director such list and any other relevant information known to the foreign corporation.

(e) *Active trade or business*—(1) *General rule.* A foreign corporation that is a resident of a foreign country shall be treated as a qualified resident of that country with respect to any U.S. trade or business if, during the taxable year—

(i) It is engaged in the active conduct of a trade or business (as defined in paragraph (e)(2) of this section) in its country of residence;

(ii) It has a substantial presence (within the meaning of paragraph (e)(3) of this section) in its country of residence; and

(iii) Either—

(A) Such U.S. trade or business is an integral part (as defined in paragraph (e)(4) of this section) of an active trade or business conducted by the foreign corporation in its country of residence; or

(B) In the case of interest received by the foreign corporation for which a treaty exemption or rate reduction is claimed pursuant to §1.884–4(b)(8)(ii), the interest is derived in connection with, or is incidental to, a trade or business described in paragraph (e)(1)(i) of this section.

A foreign corporation may determine whether it is a qualified resident under this paragraph (e) by applying the rules of this paragraph (e) to the entire affiliated group (as defined in section 1504 (a) without regard to section 1504(b) (2) or (3)) of which the foreign corporation is a member rather than to the foreign corporation separately. If a foreign corporation chooses to apply the rules of this paragraph (e) to its entire affiliated group as provided in the preceding sentence, then it must apply such rules consistently to all of its U.S. trades or businesses conducted during the taxable year.

(2) *Active conduct of a trade or business*. A foreign corporation is engaged in the active conduct of a trade or business only if either—

(i) It is engaged in the active conduct of a trade or business within the meaning of section 367(a)(3) and the regulations thereunder; or

(ii) It qualifies as a banking or financing institution under the laws of the foreign country of which it is a resident, it is licensed to do business with residents of its country of residence, and it is engaged in the active conduct of a banking, financing, or similar business within the meaning of §1.864–4(c)(5)(i) in its country of residence.

A foreign corporation that is an insurance company within the meaning of §1.801–3 (a) or (b) is engaged in the active conduct of a trade or business only if it is predominantly engaged in the active conduct of an insurance business within the meaning of section 952(c)(1)(B)(v) and the regulations thereunder.

(3) *Substantial presence test*—(i) *General rule*. Except as provided in paragraph (e)(3)(ii) of this section, a foreign corporation that is engaged in the active conduct of a trade or business in its country of residence has a substantial presence in that country if, for the taxable year, the average of the following three ratios exceeds 25 percent and each ratio is at least equal to 20 percent—

(A) The ratio of the value of the assets of the foreign corporation used or held for use in the active conduct of a trade or business in its country of residence at the close of the taxable year to the value of all assets of the foreign corporation at the close of the taxable year;

(B) The ratio of gross income from the active conduct of the foreign corporation's trade or business in its country of residence that is derived from sources within such country for the taxable year to the worldwide gross income of the foreign corporation for the taxable year; and

(C) The ratio of the payroll expenses in the foreign corporation's country of residence for the taxable year to the foreign corporation's worldwide payroll expenses for the taxable year.

(ii) *Special rules*—(A) *Asset ratio*. For purposes of paragraph (e)(3)(i)(A) of this section, the value of an asset shall be determined using the method used by the taxpayer in keeping its books for purposes of financial reporting in its country of residence. An asset shall be treated as used or held for use in a foreign corporation's trade or business if it meets the requirements of §1.367(a)–2T(b)(5). Stock held by a foreign corporation shall not be treated as an asset of the foreign corporation for purposes of paragraph (e)(3)i)(A) of this section if the foreign corporation owns 10 percent or more of the total combined voting power of all classes of stock of such corporation entitled to vote. The rules of §1.954–2T(b)(3) (other than §1.954–2T(b)(3)(x)) shall apply to determine the location of assets used or held for use in a trade or business. Loans originated or acquired in the course of the normal customer loan activities of a banking, financing or similar institution, and securities and derivative financial instruments held by

dealers, traders and insurance companies for use in a trade or business shall be treated as located in the country in which an office or other fixed place of business is primarily responsible for the acquisition of the asset and the realization of income, gain or loss with respect to the asset.

(B) *Gross income ratio—(1) General rule.* For purposes of paragraph (e)(3)(i)(B) of this section, the term ''gross income'' means the gross income of a foreign corporation for purposes of financial reporting in its country of residence. Gross income shall not include, however, dividends, interest, rent, or royalties unless such corporation derives such dividends, interest, rents, or royalties in the active conduct of its trade or business. Gross income shall also not include gain from the disposition of stock if the foreign corporation owns 10 percent or more of the total combined voting power of all classes of stock of such corporation entitled to vote. Except as provided in this paragraph (e)(3)(ii)(B), the principles of sections 861 through 865 shall apply to determine the amount of gross income of a foreign corporation derived within its country of residence.

(*2*) *Banks, dealers and traders.* Dividend income and gain from the sale of securities, or from entering into or disposing of derivative financial instruments by dealers and traders in such securities or derivative financial instruments shall be treated as derived within the country where the assets are located under paragraph (e)(3)(ii)(A) of this section. Other income, including interest and fees, earned in the active conduct of a banking, financing or similar business shall be treated as derived within the country where the payor of such interest or other income resides. For purposes of the preceding sentence, if a branch or similar establishment outside the country in which the payor resides makes a payment of interest or other income, such amounts shall be treated as derived within the country in which the branch or similar establishment is located.

(*3*) *Insurance companies.* The gross income of a foreign insurance company shall include only gross premiums received by the country.

(*4*) *Other corporations.* Gross income from the performance of services, including transportation services, shall be treated as derived within the country of residence of the person for whom the services are performed. Gross income from the sale of property by a foreign corporation shall be treated as derived within the country in which the purchaser resides.

(*5*) *Anti-abuse rule.* The Commissioner may disregard the source of income from a transaction determined under this paragraph (e)(3)(ii)(B) if it is determined that one of the principal purposes of the transaction was to increase the source of income derived within the country of residence of the foreign corporation for purposes of this section.

(C) *Payroll ratio.* For purposes of paragraph (e)(3)(i)(C) of this section, the payroll expenses of a foreign corporation shall include expenses for ''leased employees'' (within the meaning of section 414(n)(2) but without regard to subdivision (B) of that section) and commission expenses paid to employees and agents for services performed for or on behalf of the corporation. Payroll expense for an employee, agent or a ''leased employee'' shall be treated as incurred where the employee, agent or ''leased employee'' performs services on behalf of the corporation.

(iii) *Exception to gross income test for foreign corporations engaged in certain trades or businesses.* In determining whether a foreign corporation engaged primarily in selling tangible property or in manufacturing, producing, growing, or extracting tangible property has a substantial presence in its country of residence for purposes of paragraph (e)(3)(i) of this section, the foreign corporation may apply the ratio provided in this paragraph (e)(3)(iii) instead of the ratio described in paragraph (e)(3)(i)(B) of this section (relating to the ratio of gross income derived from its country of residence). This ratio shall be the ratio of the direct material costs of the foreign corporation with respect to tangible property manufactured, produced, grown, or extracted in the foreign corporation's country of residence to the total direct

material costs of the foreign corporation.

(4) *Integral part of an active trade or business in a foreign corporation's country of residence*—(i) *In general*. A U.S. trade or business of a foreign corporation is an integral part of an active trade or business conducted by a foreign corporation in its country of residence if the active trade or business conducted by the foreign corporation in both its country of residence and in the United States comprise, in principal part, complementary and mutually interdependent steps in the United States and its country of residence in the production and sale or lease of goods or in the provision of services. Subject to the presumption and de minimis rule in paragraphs (e)(4) (iii) and (iv) of this section, if a U.S. trade or business of a foreign corporation sells goods that are not, in principal part, manufactured, produced, grown, or extracted by the foreign corporation in its country of residence, such business shall not be treated as an integral part of an active trade or business conducted in the foreign corporation's country of residence unless the foreign corporation takes physical possession of the goods in a warehouse or other storage facility that is located in its country of residence and in which goods of such type are normally stored prior to sale to customers in such country.

(ii) *Presumption for banks*. A U.S. trade or business of a foreign corporation that is described in §1.884–4(a)(2)(iii) shall be presumed to be an integral part of an active banking business conducted by the foreign corporation in its country of residence provided that a substantial part of the business of the foreign corporation in both its country of residence and the United States consists of receiving deposits and making loans and discounts. This paragraph shall be effective for taxable years beginning on or after June 6, 1996.

(iii) *Presumption if business principally conducted in country of residence*. A U.S. trade or business of a foreign corporation shall be treated as an integral part of an active trade or business of a foreign corporation in its country or residence with respect to the sale or lease of property (or the performance of services) if at least 50 percent of the foreign corporation's worldwide gross income from the sale or lease of property of the type sold in the United States (or from the performance of services of the type performed in the United States) is derived from the sale or lease of such property for consumption, use, or disposition in the foreign corporation's country of residence (or from the performance of such services in the foreign corporation's country of residence). In determining whether property or services are of the same type, a foreign corporation shall follow recognized industry or trade usage or the three-digit major groups (or any narrower classification) of the Standard Industrial Classification as prepared by the Statistical Policy Division of the Office of Management and Budget, Executive Office of the President. The determination of whether income is of the same kind must be made in a consistent manner from year to year.

(iv) *De minimis rule*. If a foreign corporation is engaged in more than one U.S. trade or business and if at least 80 percent of the sum of the ECEP from the current year and the preceding two years is attributable to one or more trades or businesses that meet the integral part test of this paragraph (e)(4), all of the U.S. trades or businesses of the foreign corporation shall be treated as an integral part of an active or business conducted by the foreign corporation. If a foreign corporation has more than one U.S. trade or business and does not meet the requirements of the preceding sentence but otherwise meets the requirements of this paragraph (e)(4) with regard to one or more trade or business, see §1.884–1(g)(1) to determine the extent to which treaty benefits apply to such corporation.

(f) *Qualified resident ruling*—(1) *Basis for ruling*. In his or her sole discretion, the Commissioner may rule that a foreign corporation is a qualified resident of its country or residence if the Commissioner determines that individuals who are not residents of the foreign country of which the foreign corporation is a resident do not use the treaty between that country and the United States in a manner inconsistent with

the purposes of section 884. The purposes of section 884 include, but are not limited to, the prevention of treaty shopping by an individual with respect to any article of an income tax treaty between the country of residence of the foreign corporation and the United States.

(2) *Factors.* In order to make this determination, the Commissioner may take into account the following factors, including, but not limited to:

(i) The business reasons for establishing and maintaining the foreign corporation in its country of residence;

(ii) The date of incorporation of the foreign corporation in relation to the date that an income tax treaty between the United States and the foreign corporation's country of residence entered into force;

(iii) The continuity of the historical business and ownership of the foreign corporation;

(iv) The extent to which the foreign corporation meets the requirements of one or more of the tests described in paragraphs (b) through (e) of this section;

(v) The extent to which the U.S. trade or business is dependent on capital, assets, or personnel of the foreign trade or business;

(vi) The extent to which the foreign corporation receives special tax benefits in its country of residence;

(vii) Whether the foreign corporation is a member of an affiliated group (as defined in section 1504(a) without regard to section 1504(b) (2) or (3)), that has no members resident outside the country of residence of the foreign corporation; and

(viii) The extent to which the foreign corporation would be entitled to comparable treaty benefits with respect to all articles of an income tax treaty that would apply to that corporation if it had been incorporated in the country or countries of residence of the majority of its shareholders. For purposes of the preceding sentence, shareholders taken into account shall generally be limited to persons described in paragraph (b)(1)(i) of this section but for the fact that they are not residents of the foreign corporation's country of residence.

(3) *Procedural requirements.* A request for a ruling under this paragraph (f) must be submitted on or before the due date (including extensions) of the foreign corporation's income tax return for the taxable year for which the ruling is requested. A foreign corporation receiving a ruling will be treated as a qualified resident of its country of residence for the taxable year for which the ruling is requested and for the succeeding two taxable years. If there is a material change in any fact that formed the basis of the ruling, such as the ownership or the nature of the trade or business of the foreign corporation, the foreign corporation must notify the Secretary within 90 days of such change and submit a new private letter ruling request. The Commissioner will then rule whether the change affects the foreign corporation's status as a qualified resident, and such ruling will be valid for the taxable year in which the material change occurred and the two succeeding taxable years, subject to the requirement in the preceding sentence to notify the Commissioner of a material change.

(g) *Effective dates.* Except as provided in paragraph (e)(4)(ii) of this section, this section is effective for taxable years beginning on or after October 13, 1992. With respect to a taxable year beginning before October 13, 1992, and after December 31, 1986, a foreign corporation may elect to apply this section in lieu of the temporary regulations under 1.884–5T (as contained in the CFR edition revised as of April 1, 1992), but only if the statute of limitations for assessment of a deficiency has not expired for that taxable year. Once an election has been made, an election shall apply to all subsequent taxable years.

(h) *Transition rule.* If a foreign corporation elects to apply this section in lieu of § 1.884–5T (as contained in the CFR edition revised as of April 1, 1992) as provided in paragraph (g) of this section, and the application of paragraph (b) of this section results in additional documentation requirements in order for the foreign corporation to be treated as a qualified resident, the foreign

corporation must obtain the documentation required under that paragraph on or before March 11, 1993.

[T.D. 8432, 57 FR 41666, Sept. 11, 1992; 57 FR 49117, Oct. 29, 1992; 57 FR 60126, Dec. 18, 1992, as amended by T.D. 8657, 61 FR 9343, Mar. 8, 1996; 61 FR 14248, Apr. 1, 1996]

MISCELLANEOUS PROVISIONS

§ 1.891 Statutory provisions; doubling of rates of tax on citizens and corporations of certain foreign countries.

SEC. 891. *Doubling of rates of tax on citizens and corporations of certain foreign countries.* Whenever the President finds that, under the laws of any foreign country, citizens or corporations of the United States are being subjected to discriminatory or extraterritorial taxes, the President shall so proclaim and the rates of tax imposed by sections 1, 3, 11, 802, 821, 831, 852, 871, and 881 shall, for the taxable year during which such proclamation is made and for each taxable year thereafter, be doubled in the case of each citizen and corporation of such foreign country; but the tax at such doubled rate shall be considered as imposed by such sections as the case may be. In no case shall this section operate to increase the taxes imposed by such sections (computed without regard to this section) to an amount in excess of 80 percent of the taxable income of the taxpayer (computed without regard to the deductions allowable under section 151 and under part VIII of subchapter B). Whenever the President finds that the laws of any foreign country with respect to which the President has made a proclamation under the preceding provisions of this section have been modified so that discriminatory and extraterritorial taxes applicable to citizens and corporations of the United States have been removed, he shall so proclaim, and the provisions of this section providing for doubled rates of tax shall not apply to any citizen or corporation of such foreign country with respect to any taxable year beginning after such proclamation is made.

(Sec. 891 as amended by sec. 5(6), Life Insurance Company Tax Act 1955 (70 Stat. 49); sec. 3(f)(1), Life Insurance Company Income Tax Act 1959 (73 Stat. 140))

[T.D. 6610, 27 FR 8723, Aug. 31, 1962]

§ 1.892–1T Purpose and scope of regulations (temporary regulations).

(a) *In general.* These regulations provide guidance with respect to the taxation of income derived by foreign governments and international organizations from sources within the United States. Under section 892, certain specific types of income received by foreign governments are excluded from gross income and are exempt, unless derived from the conduct of a commercial activity or received from or by a controlled commercial entity. This section sets forth the effective date of the regulations. Section 1.892–2T defines a foreign government. In particular it describes the extent to which either an integral part of a foreign sovereign or an entity which is not an integral part of a foreign sovereign will be treated as a foreign government for purposes of section 892. Section 1.892–3T describes the types of income that generally qualify for exemption and certain limitations on the exemption. Section 1.892–4T provides rules concerning the characterization of activities as commercial activities. Section 1.892–5T defines a controlled commercial entity. Section 1.892–6T sets forth the extent to which income of international organizations from sources within the United States is excluded from gross income and is exempt from taxation. Section 1.892–7T sets forth the relationship of section 892 to other Internal Revenue Code sections.

(b) *Effective date.* The regulations set forth in §§ 1.892–1T through 1.892–7T apply to income received by a foreign government on or after July 1, 1986. No amount of income shall be required to be deducted and withheld, by reason of the amendment of section 892 by section 1247 of the Tax Reform Act of 1986 (Pub. L. 99–514, 100 Stat. 2085, 2583) from any payment made before October 22, 1986.

[T.D. 8211, 53 FR 24061, June 27, 1988; 53 FR 27595, July 21, 1988]

§ 1.892–2T Foreign government defined (temporary regulations).

(a) *Foreign government*—(1) *Definition.* The term ''foreign government'' means only the integral parts or controlled entities of a foreign sovereign.

(2) *Integral part.* An ''integral part'' of a foreign sovereign is any person, body of persons, organization, agency, bureau, fund, instrumentality, or other body, however designated, that constitutes a governing authority of a foreign country. The net earnings of the governing authority must be credited

to its own account or to other accounts of the foreign sovereign, with no portion inuring to the benefit of any private person. An integral part does not include any individual who is a sovereign, official, or administrator acting in a private or personal capacity. Consideration of all the facts and circumstances will determine whether an individual is acting in a private or personal capacity.

(3) *Controlled entity*. The term ''controlled entity'' means an entity that is separate in form from a foreign sovereign or otherwise constitute a separate juridical entity if it satisfies the following requirements:

(i) It is wholly owned and controlled by a foreign sovereign directly or indirectly through one or more controlled entities;

(ii) It is organized under the laws of the foreign sovereign by which owned;

(iii) Its net earnings are credited to its own account or to other accounts of the foreign sovereign, with no portion of its income inuring to the benefit of any private person; and

(iv) Its assets vest in the foreign sovereign upon dissolution.

A controlled entity does not include partnerships or any other entity owned and controlled by more than one foreign sovereign. Thus, a foreign financial organization organized and wholly owned and controlled by several foreign sovereigns to foster economic, financial, and technical cooperation between various foreign nations is not a controlled entity for purposes of this section.

(b) *Inurement to the benefit of private persons*. For purposes of this section, income will be presumed not to inure to the benefit of private persons if such persons (within the meaning of section 7701(a)(1)) are the intended beneficiaries of a governmental program which is carried on by the foreign sovereign and the activities of which constitute governmental functions (within the meaning of §1.892–4T(c)(4)). Income will be considered to inure to the benefit of private persons if such income benefits:

(1) Private persons through the use of a governmental entity as a conduit for personal investment; or

(2) Private persons who divert such income from its intended use by the exertion of influence or control through means explicitly or implicitly approved of by the foreign sovereign.

(c) *Pension trusts*—(1) *In general*. A controlled entity includes a separately organized pension trust if it meets the following requirements:

(i) The trust is established exclusively for the benefit of (A) employees or former employees of a foreign government or (B) employees or former employees of a foreign government and non-governmental employees or former employees that perform or performed governmental or social services;

(ii) The funds that comprise the trust are managed by trustees who are employees of, or persons appointed by, the foreign government;

(iii) The trust forming a part of the pension plan provides for retirement, disability, or death benefits in consideration for prior services rendered; and

(iv) Income of the trust satisfies the obligations of the foreign government to participants under the plan, rather than inuring to the benefit of a private person.

Income of a pension trust is subject to the rules of §1.892–5T(b)(3) regarding the application of the rules for controlled commercial entities to pension trusts. Income of a superannuation or similar pension fund of an integral part or controlled entity (which is not a separate pension trust as defined in this paragraph (c)(1)) is subject to the rules that generally apply to a foreign sovereign. Such a pension fund may also benefit non-governmental employees or former employees that perform or performed governmental or social services.

(2) *Illustrations*. The following examples illustrate the application of paragraph (c)(1).

Example 1. The Ministry of Welfare (MW), an integral part of foreign sovereign FC, instituted a retirement plan for FC's employees and former employees. Retirement benefits under the plan are based on a percentage of the final year's salary paid to an individual, times the number of years of government service. Pursuant to the plan, contributions are made by MW to a pension trust managed by persons appointed by MW to the extent actuarially necessary to fund accrued pension liabilities. The pension trust

in turn invests such contributions partially in United States Treasury obligations. The income of the trust is credited to the trust's account and subsequently used to satisfy the pension plan's obligations to retired employees. Under these circumstances, the income of the trust is not deemed to inure to the benefit of private persons. Accordingly, the trust is considered a controlled entity of FC.

Example 2. The facts are the same as in *Example* 1, except that the retirement plan also benefits employees performing governmental or social services for the following non-government institutions: (i) A university in a local jurisdiction; (ii) a harbor commission; and (iii) a library system. The retirement benefits under the plan are based on the total amounts credited to an individual's account over the term of his or her employment. MW makes annual contributions to each covered employee's account equal to a percentage of annual compensation. In addition, the income derived from investment of the annual contributions is credited annually to individual accounts. The annual contributions do not exceed an amount that is determined to be actuarially necessary to provide the employee with reasonable retirement benefits. Notwithstanding that retirement benefits vary depending upon the investment experience of the trust, no portion of the income of the trust is deemed to inure to the benefit of private persons. Accordingly, the trust is considered a controlled entity of FC.

Example 3. The facts are the same as in *Example* 1, except that employees are allowed to make unlimited contributions to the trust, and such contributions are credited to the employee's account as well as interest accrued on such contributions. Retirement benefits will reflect the amounts credited to the individual accounts in addition to the usual annuity computation based on the final year's salary and years of service. A pension plan established under these rules is in part acting as an investment conduit. As a result, the income of the trust is deemed to inure to the benefit of private persons. Accordingly, the trust is not considered a controlled entity of FC.

Example 4. (a) The facts are the same as in *Example* 2, except that MW establishes a pension fund rather than a separate pension trust. A pension fund is merely assets of an integral part or controlled entity allocated to a separate account and held and invested for purposes of providing retirement benefits. Under these circumstances, the income of the pension fund is not deemed to inure to the benefit of private persons. Accordingly, income earned from the United States Treasury obligations by the pension fund is considered to be received by a foreign government and is exempt from taxation under section 892.

(b) The facts are the same as in *Example* 4(a), except that MW is a controlled entity of foreign sovereign FC. The result is the same as in *Example* 4(a). However, should MW engage in commercial activities (whether within or outside the United States), the income from the Treasury obligations earned by the pension fund will not be exempt from taxation under section 892 since MW will be considered a controlled commercial entity within the meaning of § 1.892–5T(a).

(d) *Political subdivision and transnational entity.* The rules that apply to a foreign sovereign apply to political subdivisions of a foreign country and to transnational entities. A transnational entity is an organization created by more than one foreign sovereign that has broad powers over external and domestic affairs of all participating foreign countries stretching beyond economic subjects to those concerning legal relations and transcending state or political boundaries.

[T.D. 8211, 53 FR 24061, June 27, 1988; 53 FR 27595, July 21, 1988]

§ 1.892–3 Income of foreign governments.

(a)(1) through (a)(5) [Reserved] For further information, see § 1.892–3T(a)(1) through (a)(5).

(6) *Dividend equivalents.* Income from investments in stocks includes the payment of a dividend equivalent described in section 871(m) and the regulations thereunder.

(b) [Reserved] For further information, see § 1.892–3T(b).

(c) *Effective/applicability date.* Paragraph (a)(6) of this section applies to payments made on or after December 5, 2013.

[T.D. 9648, 78 FR 73080, Dec. 5, 2013]

§ 1.892–3T Income of foreign governments (temporary regulations).

(a) *Types of income exempt*—(1) *In general.* Subject to the exceptions contained in §§ 1.892–4T and 1.892–5T for income derived from the conduct of a commercial activity or received from or by a controlled commercial entity, the following types of income derived by a foreign government (as defined in § 1.892–2T) are not included in gross income and are exempt:

(i) Income from investments in the United States in stocks, bonds, or other securities;

(ii) Income from investments in the United States in financial instruments held in the execution of governmental financial or monetary policy; and

(iii) Interest on deposits in banks in the United States of moneys belonging to such foreign government.

Income derived from sources other than described in this paragraph (such as income earned from a U.S. real property interest described in section 897(c)(1)(A)(i)) is not exempt from taxation under section 892. Furthermore, any gain derived from the disposition a U.S. real property interest defined in section 897(c)(1)(A)(i) shall in no event qualify for exemption under section 892.

(2) *Income from investments.* For purposes of paragraph (a) of this section, income from investments in stocks, bonds or other securities includes gain from their disposition and income earned from engaging in section 1058 securities lending transactions. Gain on the disposition of an interest in a partnership or a trust is not exempt from taxation under section 892.

(3) *Securities.* For purposes of paragraph (a) of this section, the term ''other securities'' includes any note or other evidence of indebtedness. Thus, an annuity contract, a mortgage, a banker's acceptance or a loan are securities for purposes of this section.

However, the term ''other securities'' does not include partnership interests (with the exception of publicly traded partnerships within the meaning of section 7704) or trust interests. The term also does not include commodity forward or futures contracts and commodity options unless they constitute securities for purposes of section 864(b)(2)(A).

(4) *Financial instrument.* For purposes of paragraph (a) of this section, the term ''financial instrument'' includes any forward, futures, options contract, swap agreement or similar instrument in a functional or nonfunctional currency (see section 985(b) for the definition of functional currency) or in precious metals when held by a foreign government or central bank of issue (as defined in §1.895–1(b)). Nonfunctional currency or gold shall be considered a ''financial instrument'' also when physically held by a central bank of issue.

(5) *Execution of financial or monetary policy*—(i) *Rule.* A financial instrument shall be deemed held in the execution of governmental financial or monetary policy if the primary purpose for holding the instrument is to implement or effectuate such policy.

(ii) *Illustration.* The following example illustrates the application of this paragraph (a)(5).

Example. In order to ensure sufficient currency reserves, the monetary authority of foreign country FC issues short-term government obligations. The amount received from the obligations is invested in U.S. financial instruments. Since the primary purpose for obtaining the U.S. financial instruments is to implement FC's monetary policy, the income received from the financial instruments is exempt from taxation under section 892.

(b) *Illustrations.* The principles of paragraph (a) of this section may be illustrated by the following examples.

Example 1. X, a foreign corporation not engaged in commercial activity anywhere in the world, is a controlled entity of a foreign sovereign within the meaning of §1.892–2T(a)(3). X is not a Central bank of issue as defined in §1.895–1(b). In 1987, X received the following items of income from investments in the United States: (i) Dividends from a portfolio of publicly traded stocks in U.S. corporations in which X owns less than 50 percent of the stock; (ii) dividends from BTB Corporation, an automobile manufacturer, in which X owns 50 percent of the stock; (iii) interest from bonds issued by noncontrolled entities and from interest-bearing bank deposits in noncontrolled entities; (iv) rents from a net lease on real property; (v) gains from silver futures contracts; (vi) gains from wheat futures contracts; (vii) gains from spot sales of nonfunctional foreign currency in X's possession; (viii) gains from the disposition of a publicly traded partnership interest, and (ix) gains from the disposition of the stock of Z Corporation, a United States real property holding company as defined in section 897, of which X owns 12 percent of the stock. Only income derived from sources described in paragraph (a)(1) of this section is treated as income of a foreign government eligible for exemption from taxation. Accordingly, only income received by X from items (i), (iii), (v) provided that the silver futures contracts are held in the execution of governmental financial or monetary policy,

and (ix) is exempt from taxation under section 892.

Example 2. The facts are the same as in *Example* 1, except that X is also a central bank of issue within the meaning of section 895. Since physical possession of nonfunctional foreign currency when held by a central bank of issue is considered a financial instrument, the item (vii) gains from spot sales of nonfunctional foreign currency are exempt from taxation under paragraph (a)(1) of this section, if physical possession of the currency was an essential part of X's reserve policy in the execution of its governmental financial or monetary policy.

Example 3. State Concert Bureau, an integral part of a foreign sovereign within the meaning of §1.892–2T(a)(2), entered into an agreement with a U.S. corporation engaged in the business of promoting international cultural programs. Under the agreement the State Concert Bureau agreed to send a ballet troupe on tour for 5 weeks in the United States. The Bureau received approximately $60,000 from the performances. Regardless of whether the performances themselves constitute commercial activities under §1.892–4T, the income received by the Bureau is not exempt from taxation under section 892 since the income is from sources other than described in paragraph (a)(1) of this section.

[T.D. 8211, 53 FR 24062, June 27, 1988]

§1.892–4T Commercial activities (temporary regulations).

(a) *Purpose.* The exemption generally applicable to a foreign government (as defined in §1.892–2T) for income described in §1.892–3T does not apply to income derived from the conduct of a commercial activity or income received by a controlled commercial entity or received (directly or indirectly) from a controlled commercial entity. This section provides rules for determining whether income is derived from the conduct of a commercial activity. These rules also apply in determining under §1.892–5T whether an entity is a controlled commercial entity.

(b) *In general.* Except as provided in paragraph (c) of this section, all activities (whether conducted within or outside the United States) which are ordinarily conducted by the taxpayer or by other persons with a view towards the current or future production of income or gain are commercial activities. An activity may be considered a commercial activity even if such activity does not constitute the conduct of a trade or business in the United States under section 864(b).

(c) *Activities that are not commercial*—(1) *Investments*—(i) *In general.* Subject to the provisions of paragraphs (ii) and (iii) of this paragraph (c)(1), the following are not commercial activities: Investments in stocks, bonds, and other securities; loans; investments in financial instruments held in the execution of governmental financial or monetary policy; the holding of net leases on real property or land which is not producing income (other than on its sale or from an investment in net leases on real property); and the holding of bank deposits in banks. Transferring securities under a loan agreement which meets the requirements of section 1058 is an investment for purposes of this paragraph (c)(1)(i). An activity will not cease to be an investment solely because of the volume of transactions of that activity or because of other unrelated activities.

(ii) *Trading.* Effecting transactions in stocks, securities, or commodities for a foreign government's own account does not constitute a commercial activity regardless of whether such activities constitute a trade or business for purposes of section 162 or a U.S. trade or business for purposes of section 864. Such transactions are not commercial activities regardless of whether they are effected by the foreign government through its employees or through a broker, commission agent, custodian, or other independent agent and regardless of whether or not any such employee or agent has discretionary authority to make decisions in effecting the transactions. An activity undertaken as a dealer, however, as defined in §1.864–2(c)(2)(iv)(*a*) will not be an investment for purposes of this paragraph (c)(1)(i). For purposes of this paragraph (c)(1)(ii), the term ''commodities'' means commodities of a kind customarily dealt in on an organized commodity exchange but only if the transaction is of a kind customarily consummated at such place.

(iii) *Banking, financing, etc.* Investments (including loans) made by a banking, financing, or similar business constitute commercial activities, even if the income derived from such investments is not considered to be income

effectively connected to the active conduct of a banking, financing, or similar business in the U.S. by reason of the application of § 1.864–4(c)(5).

(2) *Cultural events.* Performances and exhibitions within or outside the United States of amateur athletic events and events devoted to the promotion of the arts by cultural organizations are not commercial activities.

(3) *Non-profit activities.* Activities that are not customarily attributable to or carried on by private enterprise for profit are not commercial activities. The fact that in some instances Federal, State, or local governments of the United States also are engaged in the same or similar activity does not mean necessarily that it is a non-profit activity. For example, even though the United States Government may be engaged in the activity of operating a railroad, operating a railroad is not a non-profit activity.

(4) *Governmental functions.* Governmental functions are not commercial activities. The term ''governmental functions'' shall be determined under U.S. standards. In general, activities performed for the general public with respect to the common welfare or which relate to the administration of some phase of government will be considered governmental functions. For example, the operation of libraries, toll bridges, or local transportation services and activities substantially equivalent to the Federal Aviation Authority, Interstate Commerce Commission, or United States Postal Service will all be considered governmental functions for purposes of this section.

(5) *Purchasing.* The mere purchasing of goods for the use of a foreign government is not a commercial activity.

[T.D. 8211, 53 FR 24063, June 27, 1988]

§ 1.892–5 Controlled commercial entity.

(a)–(a)(2) [Reserved]. For further information, see § 1.892–5T(a) through (a)(2).

(3) For purposes of section 892(a)(2)(B), the term *entity* means and includes a corporation, a partnership, a trust (including a pension trust described in § 1.892–2T(c)) and an estate.

(4) *Effective date.* This section applies on or after January 14, 2002. See § 1.892–5T(a) for the rules that apply before January 14, 2002.

(b)–(d) [Reserved]. For further information, see §§ 1.892–5T(b) through (d).

[T.D. 9012, 67 FR 49864, Aug. 1, 2002]

§ 1.892–5T Controlled commercial entity (temporary regulations).

(a) *In general.* The exemption generally applicable to a foreign government (as defined in § 1.892–2T) for income described in § 1.892–3T does not apply to income received by a controlled commercial entity or received (directly or indirectly) from a controlled commercial entity. The term ''controlled commercial entity'' means any entity engaged in commercial activities as defined in § 1.892–4T (whether conducted within or outside the United States) if the government—

(1) Holds (directly or indirectly) any interest in such entity which (by value or voting power) is 50 percent or more of the total of such interests in such entity, or

(2) Holds (directly or indirectly) a sufficient interest (by value or voting power) or any other interest in such entity which provides the foreign government with effective practical control of such entity.

(3) [Reserved]. For further information, see § 1.892–5(a)(3).

(b) Entities treated as engaged in commercial activity—(1) *U.S. real property holding corporations.* A United States real property holding corporation, as defined in section 897(c)(2) or a foreign corporation that would be a United States real property holding corporation if it was a United States corporation, shall be treated as engaged in commercial activity and, therefore, is a controlled commercial entity if the requirements of paragraph (a)(1) or (a)(2) of this section are satisfied.

(2) *Central banks.* Notwithstanding paragraph (a) of this section, a central bank of issue (as defined in § 1.895–1(b)) shall be treated as a controlled commercial entity only if it engages in commercial activities within the United States.

(3) *Pension trusts.* A pension trust, described in § 1.892–2T(c), which engages in commercial activities within or outside the United States, shall be treated

as a controlled commercial entity. Income derived by such a pension trust is not income of a foreign government for purposes of the exemption from taxation provided in section 892. A pension trust described in § 1.892–2T(c) shall not be treated as a controlled commercial entity if such trust solely earns income which would not be unrelated business taxable income (as defined in section 512(a)(1)) if the trust were a qualified trust described in section 401(a). However, only income derived by a pension trust that is described in § 1.892–3T and which is not from commercial activities as defined in § 1.892–4T is exempt from taxation under section 892.

(c) *Control*—(1) *Attribution*—(i) *Rule*. In determining for purposes of paragraph (a) of this section the interest held by a foreign government, any interest in an entity (whether or not engaged in commercial activity) owned directly or indirectly by an integral part or controlled entity of a foreign sovereign shall be treated as actually owned by such foreign sovereign.

(ii) *Illustration*. The following example illustrates the application of paragraph (c)(1)(i) of this section.

Example. FX, a controlled entity of foreign sovereign FC, owns 20 percent of the stock of Corp 1. Neither FX nor Corp 1 is engaged in commercial activity anywhere in the world. Corp 1 owns 60 percent of the stock of Corp 2, which is engaged in commercial activity. The remaining 40 percent of Corp 2's stock is owned by Bureau, an integral part of foreign sovereign FC. For purposes of determining whether Corp 2 is a controlled commercial entity of FC, Bureau will be treated as actually owning the 12 percent of Corp 2's stock indirectly owned by FX. Therefore, since Bureau directly and indirectly owns 52 percent of the stock of Corp 2, Corp 2 is a controlled commercial entity of FC within the meaning of paragraph (a) of this section. Accordingly, dividends or other income received, directly or indirectly, from Corp 2 by either Bureau or FX will not be exempt from taxation under section 892. Furthermore, dividends from Corp 1 to the extent attributable to dividends from Corp 2 will not be exempt from taxation. Thus, a distribution from Corp 1 to FX shall be exempt only to the extent such distribution exceeds Corp 1's earnings and profits attributable to the Corp 2 dividend amount received by Corp 1.

(2) *Effective practical control*. An entity engaged in commercial activity may be treated as a controlled commercial entity if a foreign government holds sufficient interests in such entity to give it ''effective practical control'' over the entity. Effective practical control may be achieved through a minority interest which is sufficiently large to achieve effective control, or through creditor, contractual, or regulatory relationships which, together with ownership interests held by the foreign government, achieve effective control. For example, an entity engaged in commercial activity may be treated as a controlled commercial entity if a foreign government, in addition to holding a small minority interest (by value or voting power), is also a substantial creditor of the entity or controls a strategic natural resource which such entity uses in the conduct of its trade or business, giving the foreign government effective practical control over the entity.

(d) *Related controlled entities*—(1) *Brother/sister entities*. Commercial activities of a controlled entity are not attributed to such entity's other brother/sister related entities. Thus, investment income described in § 1.892–2T that is derived by a controlled entity that is not itself engaged in commercial activity within or outside the United States is exempt from taxation notwithstanding the fact that such entity's brother/sister related entity is a controlled commercial entity.

(2) *Parent/subsidiary entities*—(i) *Subsidiary to parent attribution*. Commercial activities of a subsidiary controlled entity are not attributed to its parent. Thus, investment income described in § 1.892–3T that is derived by a parent controlled entity that is not itself engaged in commercial activity within or outside the United States is exempt from taxation notwithstanding the fact that its subsidiary is a controlled commercial entity. Dividends or other payments of income received by the parent controlled entity from the subsidiary are not exempt under section 892, because it constitutes income received from a controlled commercial entity. Furthermore, dividends paid by the parent are not exempt to the extent attributable to the dividends received by the parent from the subsidiary. Thus, a distribution by the

parent shall be exempt only to the extent such distribution exceeds earnings and profits attributable to the dividend received from its subsidiary.

(ii) *Parent to subsidiary attribution.* Commercial activities of a parent controlled entity are attributed to its subsidiary. Thus, investment income described in §1.892–3T that is derived by a subsidiary controlled entity (not engaged in commercial activity within or outside the United States) is not exempt from taxation under section 892 if its parent is a controlled commercial entity.

(3) *Partnerships.* Except for partners of publicly traded partnerships, commercial activities of a partnership are attributable to its general and limited partners for purposes of section 892. For example, where a controlled entity is a general partner in a partnership engaged in commercial activities, the controlled entity's distributive share of partnership income (including income described in §1.892–3T) will not be exempt from taxation under section 892.

(4) *Illustrations.* The principles of this section may be illustrated by the following examples.

Example 1. (a) The Ministry of Industry and Development is an integral part of a foreign sovereign under §1.892–2T(a)(2). The Ministry is engaged in commercial activity within the United States. In addition, the Ministry receives income from various publicly traded stocks and bonds, soybean futures contracts and net leases on U.S. real property. Since the Ministry is an integral part, and not a controlled entity, of a foreign sovereign, it is not a controlled commercial entity within the meaning of paragraph (a) of this section. Therefore, income described in §1.892–3T is ineligible for exemption under section 892 only to the extent derived from the conduct of commercial activities. Accordingly, the Ministry's income from the stocks and bonds is exempt from U.S. tax.

(b) The facts are the same as in *Example* (1)(a), except that the Ministry also owns 75 percent of the stock of R, a U.S. holding company that owns all the stock of S, a U.S. operating company engaged in commercial activity. Ministry's dividend income from R is income received indirectly from a controlled commercial entity. The Ministry's income from the stocks and bonds, with the exception of dividend income from R, is exempt from U.S. tax.

(c) The facts are the same as in *Example* (1)(a), except that the Ministry is a controlled entity of a foreign sovereign. Since the Ministry is a controlled entity and is engaged in commercial activity, it is a controlled commercial entity within the meaning of paragraph (a) of this section, and none of its income is eligible for exemption.

Example 2. (a) Z, a controlled entity of a foreign sovereign, has established a pension trust as part of a pension plan for the benefit of its employees and former employees. The pension trust (T), which meets the requirements of §1.892–2T(c), has investments in the U.S. in various stocks, bonds, annuity contracts, and a shopping center which is leased and managed by an independent real estate management firm. T also makes securities loans in transactions that qualify under section 1058. T's investment in the shopping center is not considered an unrelated trade or business within the meaning of section 513(b). Accordingly, T will not be treated as engaged in commercial activity. Since T is not a controlled commercial entity, its investment income described in §1.892–3T, with the exception of income received from the operations of the shopping center, is exempt from taxation under section 892.

(b) The facts are the same as *Example* (2)(a), except that T has an interest in a limited partnership which owns the shopping center. The shopping center is leased and managed by the partnership rather than by an independent management firm. Managing a shopping center, directly or indirectly through a partnership of which a trust is a member, would be considered an unrelated trade or business within the meaning of section 513(b) giving rise to unrelated business taxable income. Since the commercial activities of a partnership are attributable to its partners, T will be treated as engaged in commercial activity and thus will be considered a controlled commercial entity. Accordingly, none of T's income will be exempt from taxation under section 892.

(c) The facts are the same as *Example* (2)(a), except that Z is a controlled commercial entity. The result is the same as in *Example* (2)(a).

Example 3. (a) The Department of Interior, an integral part of foreign sovereign FC, wholly owns corporations G and H. G, in turn, wholly owns S. G, H and S are each controlled entities. G, which is not engaged in commercial activity anywhere in the world, receives interest income from deposits in banks in the United States. Both H and S do not have any investments in the U.S. but are both engaged in commercial activities. However, only S is engaged in commercial activities within the United States. Because neither the commercial activities of H nor the commercial activities of S are attributable to the Department of Interior or G, G's interest income is exempt from taxation under section 892.

(b) The facts are the same as *Example* (3)(a), except that G rather than S is engaged

in commercial activities and S rather than G receives the interest income from the United States. Since the commercial activities of G are attributable to S, S's interest income is not exempt from taxation.

Example 4. (a) K, a controlled entity of a foreign sovereign, is a general partner in the Daj partnership. The Daj partnership has investments in the U.S. in various stocks and bonds and also owns and manages an office building in New York. K will be deemed to be engaged in commercial activity by being a general partner in Daj even if K does not actually make management decisions with regard to the partnership's commercial activity, the operation of the office building. Accordingly K's distributive share of partnership income (including income derived from stocks and bonds) will not be exempt from taxation under section 892.

(b) The facts are the same as in *Example* (4)(a), except that the Daj partnership has hired a real estate management firm to lease offices and manage the building. Notwithstanding the fact that an independent contractor is performing the activities, the partnership shall still be deemed to be engaged in commercial activity. Accordingly, K's distributive share of partnership income (including income derived from stocks and bonds) will not be exempt from taxation under section 892.

(c) The facts are the same as in *Example* (4)(a), except that K is a partner whose partnership interest is considered a publicly traded partnership interest within the meaning of section 7704. Under paragraph (d)(3) of this section, the partnership's commercial activity will not be attributed to K. Since K will not be deemed to be engaged in commercial activity, K's distributive share of partnership income derived from stocks and bonds will be exempt from taxation under section 892.

[T.D. 8211, 53 FR 24064, June 27, 1988, as amended by T.D. 9012, 67 FR 49864, Aug. 1, 2002]

§ 1.892–6T Income of international organizations (temporary regulations).

(a) *Exempt from tax.* Subject to the provisions of section 1 of the International Organizations Immunities Act (22 U.S.C. 288) (the provisions of which are set forth in paragraph (b)(3) of § 1.893–1), the income of an international organization (as defined in section 7701(a)(18)) received from investments in the United States in stocks, bonds, or other domestic securities, owned by such international organization, or from interest on deposits in banks in the United States of moneys belonging to such international organization, or from any other source within the United States, is exempt from Federal income tax.

(b) *Income received prior to Presidential designation.* An organization designated by the President through appropriate Executive order as entitled to enjoy the privileges, exemptions, and immunities provided in the International Organizations Immunities Act may enjoy the benefits of the exemption with respect to income of the prescribed character received by such organization prior to the date of the issuance of such Executive order, if (i) the Executive order does not provide otherwise and (ii) the organization is a public international organization in which the United States participates, pursuant to a treaty or under the authority of an act of Congress authorizing such participation or making an appropriation for such participation, at the time such income is received.

[T.D. 8211, 53 FR 24065, June 27, 1988]

§ 1.892–7T Relationship to other Internal Revenue Code sections (temporary regulations).

(a) *Section 893.* The term ''foreign government'' referred to in section 893 (relating to the exemption for compensation of employees of foreign governments) has the same meaning as given such term in § 1.892–2T.

(b) *Section 895.* A foreign central bank of issue (as defined in § 1.895–1(b)) that fails to qualify for the exemption from tax provided by this section (for example, it is not wholly owned by a foreign sovereign) may nevertheless be exempt from tax on the items of income described in section 895.

(c) *Section 883(b).* Nothing in section 892 or these regulations shall limit the exemption provided under section 883(b) relating generally to the exemption of earnings derived by foreign participants from the ownership or operation of communications satellite systems.

(d) *Section 884.* Earnings and profits attributable to income of a controlled entity of a foreign sovereign which is exempt from taxation under section 892 shall not be subject to the tax imposed by section 884(a).

(e) *Sections 1441 and 1442.* No withholding is required under sections 1441 and 1442 in the case of income exempt from taxation under section 892.

[T.D. 8211, 53 FR 24066, June 27, 1988]

§ 1.893–1 Compensation of employees of foreign governments or international organizations.

(a) *Employees of foreign governments*—(1) *Exempt from tax.* Except to the extent that the exemption is limited by the execution and filing of the waiver provided for in section 247(b) of the Immigration and Nationality Act (8 U.S.C. 1257(b)), all employees of a foreign government (including consular or other officers, or nondiplomatic representatives) who are not citizens of the United States, or are citizens of the Republic of the Philippines (whether or not citizens of the United States), are exempt from Federal income tax with respect to wages, fees, or salaries received by them as compensation for official services rendered to such foreign government, provided (i) the services are of a character similar to those performed by employees of the Government of the United States in that foreign country and (ii) the foreign government whose employees are claiming exemption grants an equivalent exemption to employees of the Government of the United States performing similar services in that foreign country.

(2) *Certificate by Secretary of State.* Section 893(b) provides that the Secretary of State shall certify to the Secretary of the Treasury the names of the foreign countries which grant an equivalent exemption to the employees of the Government of the United States performing services in such foreign countries, and the character of the services performed by employees of the Government of the United States in foreign countries.

(3) *Items not exempt.* The income received by employees of foreign governments from sources other than their salaries, fees, or wages, referred to in subparagraph (1) of this paragraph, is subject to Federal income tax.

(4) *Immigration and Nationality Act.* Section 247(b) of the Immigration and Nationality Act provides as follows:

Sec. 247. Adjustment of status of certain resident aliens.* * *

(b) The adjustment of status required by subsection (a) [of section 247 of the Immigration and Nationality Act] shall not be applicable in the case of any alien who requests that he be permitted to retain his status as an immigrant and who, in such form as the Attorney General may require, executes and files with the Attorney General a written waiver of all rights, privileges, exemptions, and immunities under any law or any executive order which would otherwise accrue to him because of the acquisition of an occupational status entitling him to a nonimmigrant status under paragraph (15)(A), (15)(E), or (15)(G) of section 101(a).

(5) *Effect of waiver.* An employee of a foreign government who executes and files with the Attorney General the waiver provided for in section 247(b) of the Immigration and Nationality Act thereby waives the exemption conferred by section 893 of the Code. As a consequence, that exemption does not apply to income received by that alien after the date of filing of the waiver.

(6) *Citizens of the United States.* The compensation of citizens of the United States (other than those who are also citizens of the Republic of the Philippines) who are officers or employees of a foreign government is not exempt from income tax pursuant to this paragraph. But see section 911 and the regulations thereunder.

(b) *Employees of international organizations*—(1) *Exempt from tax.* Except to the extent that the exemption is limited by the execution and filing of the waiver provided for in section 247(b) of the Immigration and Nationality Act and subject to the provisions of sections 1, 8, and 9 of the International Organizations Immunities Act (22 U.S.C. 288, 288e, 288f), wages, fees, or salary of any officer or employee of an international organization (as defined in section 7701(a)(18)) received as compensation for official services to that international organization is exempt from Federal income tax, if that officer or employee (i) is not a citizen of the United States or (ii) is a citizen of the Republic of the Philippines (whether or not a citizen of the United States).

(2) *Income earned prior to executive action.* An individual of the prescribed class who receives wages, fees, or salary as compensation for official services to an organization designated by

the President through appropriate Executive order as entitled to enjoy the privileges, exemptions, and immunities provided in the International Organizations Immunities Act and who has been duly notified to, and accepted by, the Secretary of State as an officer or employee of that organization, or who has been designated by the Secretary of State, prior to formal notification and acceptance, as a prospective officer or employee of that organization, may enjoy the benefits of the exemption with respect to compensation of the prescribed character earned by that individual, either prior to the date of the Issuance of the Executive order, or prior to the date of the acceptance or designation by the Secretary of State, for official services to that organization, if (i) the Executive order does not provide otherwise, (ii) the organization is a public international organization in which the United States participates, pursuant to a treaty or under the authority of an act of Congress authorizing such participation or making an appropriation for such participation, at the time the compensation is earned, and (iii) the individual is an officer or employee of that organization at that time.

(3) *International Organizations Immunities Act*. Sections 1, 8, and 9 of the International Organizations Immunities Act (22 U.S.C. 288, 288e, 288f) provide in part as follows:

SECTION 1. For the purposes of this title [International Organizations Immunities Act], the term ''international organization'' means a public international organization in which the United States participates pursuant to any treaty or under the authority of any Act of Congress authorizing such participation or making an appropriation for such participation, and which shall have been designated by the President through appropriate Executive order as being entitled to enjoy the privileges, exemptions, and immunities herein provided. The President shall be authorized, in the light of the functions performed by any such international organization, by appropriate Executive order to withhold or withdraw from any such organization or its officers or employees any of the privileges, exemptions, and immunities provided for in this title (including the amendments made by this title) or to condition or limit the enjoyment by any such organization or its officers or employees of any such privilege, exemption, or immunity. The President shall be authorized, if in his judgment such action should be justified by reason of the abuse by an international organization or its officers and employees of the privileges, exemptions, and immunities herein provided or for any other reason, at any time to revoke the designation of any international organization under this section, whereupon the international organization in question shall cease to be classed as an international organization for the purposes of this title.

* * * * *

SEC. 8. (a) No person shall be entitled to the benefits of this title [International Organizations Immunities Act] unless he (1) shall have been duly notified to and accepted by the Secretary of State as a * * * officer, or employee; or (2) shall have been designated by the Secretary of State, prior to formal notification and acceptance, as a prospective * * * officer, or employee; * * *.

(b) Should the Secretary of State determine that the continued presence in the United States of any person entitled to the benefits of this title is not desirable, he shall so inform the * * * international organization concerned * * *, and after such person shall have had a reasonable length of time, to be determined by the Secretary of State, to depart from the United States, he shall cease to be entitled to such benefits.

(c) No person shall, by reason of the provisions of this title, be considered as receiving diplomatic status or as receiving any of the privileges incident thereto other than such as are specifically set forth herein.

SEC. 9. The privileges, exemptions, and immunities of international organizations and of their officers and employees * * * provided for in this title [International Organizations Immunities Act], shall be granted notwithstanding the fact that the similar privileges, exemptions, and immunities granted to a foreign government, its officers, or employees, may be conditioned upon the existence of reciprocity by that foreign government: *Provided*, That nothing contained in this title shall be construed as precluding the Secretary of State from withdrawing the privileges, exemptions, and immunities herein provided from persons who are nationals of any foreign country on the ground that such country is failing to accord corresponding privileges, exemptions, and immunities to citizens of the United States.

(4) *Effect of waiver*. An officer or employee of an international organization who executes and files with the Attorney General the waiver provided for in section 247(b) of the Immigration and Nationality Act (8 U.S.C. 1257(b)) thereby waives the exemption conferred by

section 893 of the Code. As a consequence, that exemption does not apply to income received by that individual after the date of filing of the waiver.

(5) *Citizens of the United States.* The compensation of citizens of the United States (other than those who are also citizens of the Republic of the Philippines) who are officers or employees of an international organization is not exempt from income tax pursuant to this paragraph. But see section 911 and the regulations thereunder.

(c) *Tax conventions, consular conventions, and international agreements*—(1) *Exemption dependent upon internal revenue laws.* A tax convention or consular convention between the United States and a foreign country, which provides that the United States may include in the tax base of its residents all income taxable under the internal revenue laws, and which makes no specific exception for the income of the employees of that foreign government, does not provide any exemption (with respect to residents of the United States) beyond that which is provided by the internal revenue laws. Accordingly, the effect of the execution and filing of a waiver under section 247(b) of the Immigration and Nationality Act by an employee of a foreign government which is a party to such a convention is to subject the employee to tax to the same extent as provided in paragraph (a)(5) of this section with respect to the waiver of exemption under section 893.

(2) *Exemption not dependent upon internal revenue laws.* If a tax convention, consular convention, or international agreement provides that compensation paid by the foreign government or international organization to its employees is exempt from Federal income tax, and the application of this exemption is not dependent upon the provisions of the internal revenue laws, the exemption so conferred is not affected by the execution and filing of a waiver under section 247(b) of the Immigration and Nationality Act. For examples of exemptions which are not affected by the Immigration and Nationality Act, see article X of the income tax convention between the United States and the United Kingdom (60 Stat. 1383); article IX, section 9(b), of the Articles of Agreement of the International Monetary Fund (60 Stat. 1414); and article VII, section 9(b), of the Articles of Agreement of the International Bank for Reconstruction and Development (60 Stat. 1458).

§ 1.894–1 Income affected by treaty.

(a) *Income exempt under treaty.* Income of any kind is not included in gross income and is exempt from tax under Subtitle A (relating to income taxes), to the extent required by any income tax convention to which the United States is a party. However, unless otherwise provided by an income tax convention, the exclusion from gross income under section 894(a) and this paragraph does not apply in determining the accumulated taxable income of a foreign corporation under section 535 and the regulations thereunder or the undistributed personal holding company income of a foreign corporation under section 545 and the regulations thereunder. Moreover, the distributable net income of a foreign trust is determined without regard to section 894 and this paragraph, to the extent provided by section 643(a)(6)(B). Further, the compensating tax adjustment required by section 819(a)(3) in the case of a foreign life insurance company is to be determined without regard to section 894 and this paragraph, to the extent required by section 819(a)(3)(A). See § 1.871–12 for the manner of determining the tax liability of a nonresident alien individual or foreign corporation whose gross income includes income on which the tax is reduced under a tax convention.

(b) *Taxpayer treated as having no permanent establishment in the United States*—(1) *In general.* A nonresident alien individual or a foreign corporation, that is engaged in trade or business in the United States through a permanent establishment located therein at any time during a taxable year beginning after December 31, 1966, shall be deemed not to have a permanent establishment in the United States at any time during that year for purposes of applying any exemption from, or reduction in the rate of, any tax under Subtitle A of the Code which is provided by any income tax convention with respect to income which is

not effectively connected for that year with the conduct of a trade or business in the United States by the taxpayer. This paragraph applies to all treaties or conventions entered into by the United States, whether entered into before, on, or after November 13, 1966, the date of enactment of the Foreign Investors Tax Act of 1966 (80 Stat. 1539). This paragraph is not considered to be contrary to any obligation of the United States under an income tax convention to which it is a party. The benefit granted under section 894(b) and this paragraph applies only to those items of income derived from sources within the United States which are subject to the tax imposed by section 871(a) or 881(a), and section 1441, 1442, or 1451, on the noneffectively connected income received from sources within the United States by a nonresident alien individual or a foreign corporation. The benefit does not apply to any income from real property in respect of which an election is in effect for the taxable year under §1.871–10 or in determining under section 877(b) the tax of a nonresident alien individual who has lost United States citizenship at any time after March 8, 1965. The benefit granted by section 894(b) and this paragraph is not elective.

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

Example 1. M, a corporation organized in foreign country X, uses the calendar year as the taxable year. The United States and country X are parties to an income tax convention which provides in part that dividends received from sources within the United States by a corporation of country X not having a permanent establishment in the United States are subject to tax under Chapter 1 of the Code at a rate not to exceed 15 percent. During 1967, M is engaged in business in the United States through a permanent establishment located therein and receives $100,000 in dividends from domestic corporation B, which under section 861(a)(2)(A) constitute income from sources within the United States. Under section 864(c)(2) and §1.864–4(c), the dividends received from B are not effectively connected for 1967 with the conduct of a trade or business in the United States by M. Although M has a permanent establishment in the United States during 1967, it is deemed, under section 894(b) and this paragraph, not to have a permanent establishment in the United States during that year with respect to the dividends. Accordingly, in accordance with paragraph (c)(3) of §1.871–12 the tax on the dividends is $15,000, that is, 15 percent of $100,000, determined without the allowance of any deductions.

Example 2. T, a corporation organized in foreign country X, uses the calendar year as the taxable year. The United States and country X are parties to an income tax convention which provides in part that an enterprise of country X is not subject to tax under chapter 1 of the Code in respect of its industrial or commercial profits unless it is engaged in trade or business in the United States during the taxable year through a permanent establishment located therein and that, if it is so engaged, the tax may be imposed upon the entire income of that enterprise from sources within the United States. The convention also provides that the tax imposed by Chapter 1 of the Code on dividends received from sources within the United States by a corporation of X which is not engaged in trade or business in the United States through a permanent establishment located therein shall not exceed 15 percent of the dividend. During 1967, T is engaged in a business (business A) in the United States which is carried on through a permanent establishment in the United States; in addition, T is engaged in a business (business B) in the United States which is not carried on through a permanent establishment. During 1967, T receives from sources within the United States $60,000 in service fees through the operation of business A and $10,000 in dividends through the operation of business B, both of which amounts are, under section 864(c)(2)(B) and §1.864–4(c)(3), effectively connected for that year with the conduct of a trade or business in the United States by that corporation. The service fees are considered to be industrial or commercial profits under the tax convention with country X. Since T has no income for 1967 which is not effectively connected for that year with the conduct of a trade or business in the United States by that corporation, section 894(b), this paragraph, and §1.871–12 do not apply. Accordingly, for 1967 T's entire income of $70,000 from sources within the United States is subject to tax, after allowance of deductions, in accordance with section 882(a)(1) and paragraph (b)(2) of §1.882–1.

Example 3. S, a corporation organized in foreign country W, uses the calendar year as the taxable year. The United States and country W are parties to an income tax convention which provides in part that a corporation of country W is not subject to tax under Chapter 1 of the Code in respect of its industrial or commercial profits unless it is engaged in trade or business in the United States during the taxable year through a permanent establishment located therein and that, if it is so engaged, the tax may be

imposed upon the entire income of that corporation from sources within the United States. The convention also provides that the tax imposed by Chapter 1 of the Code on dividends received from sources within the United States by a corporation of country W which is not engaged in trade or business in the United States through a permanent establishment located therein shall not exceed 15 percent of the dividend. During 1967, S is engaged in business in the United States through a permanent establishment located therein and derives from sources within the United States $100,000 in service fees which, under section 864(c)(2)(B) and §1.864–4(c)(3), are effectively connected for that year with the conduct of a trade or business in the United States by S and which are considered to be industrial or commercial profits under the tax convention with country W. During 1967, S also derives from sources within the United States, through another business it carries on in foreign country X, $10,000 in sales income which, under section 864(c)(3) and §1.864–4(b), is effectively connected for that year with the conduct of a trade or business in the United States by S and $5,000 in dividends which, under section 864(c)(2)(A) and §1.864–4(c)(2), are not effectively connected for that year with the conduct of a trade or business in the United States by S. The sales income is considered to be industrial or commercial profits under the tax convention with country W. Although S is engaged in a trade or business in the United States during 1967 through a permanent establishment located therein, it is deemed, under section 894(b) and this paragraph, not to have a permanent establishment therein with respect to the $5,000 in dividends. Accordingly, in accordance with paragraph (c) of §1.871–12, for 1967 S is subject to a tax of $750 on the dividends ($5,000 × .15) and a tax, determined under section 882(a) and §1.882–1, on its $110,000 industrial or commercial profits.

Example 4. (a) N, a corporation organized in foreign country Z, uses the calendar year as the taxable year. The United States and country Z are parties to an income tax convention which provides in part that the tax imposed by Chapter 1 of the Code on dividends received from sources within the United States by a corporation of country Z shall not exceed 15 percent of the amount distributed if the recipient does not have a permanent establishment in the United States or, where the recipient does have a permanent establishment in the United States, if the shares giving rise to the dividends are not effectively connected with the permanent establishment. The tax convention also provides that if a corporation of country Z is engaged in industrial or commercial activity in the United States through a permanent establishment in the United States, income tax may be imposed by the United States on so much of the industrial or commercial profits of such corporation as are attributable to the permanent establishment in the United States.

(b) During 1967, N is engaged in a business (business A) in the United States which is not carried on through a permanent establishment in the United States. In addition, N has a permanent establishment in the United States through which it carries on another business (business B) in the United States. During 1967, N holds shares of stock in domestic corporation D which are not effectively connected with N's permanent establishment in the United States. During 1967, N receives $100,000 in dividends from D which, pursuant to section 864(c)(2)(A) and §1.864–4(c)(2), are effectively connected for that year with the conduct of business A. Under section 861(a)(2)(A) these dividends are treated as income from sources within the United States. In addition, during 1967, N receives from sources within the United States $150,000 in sales income which, pursuant to section 864(c)(3) and §1.864–4(b), is effectively connected with the conduct of a trade or business in the United States and which is considered to be industrial or commercial profits under the tax convention with country Z. Of these total profits, $70,000 is from business A and $80,000 is from business B. Only the $80,000 of industrial or commercial profits is attributable to N's permanent establishment in the United States.

(c) Since N has no income for 1967 which is not effectively connected for that year with the conduct of a trade or business in the United States by that corporation, section 894(b) and this paragraph do not apply. However, N is entitled to the reduced rate of tax under the tax convention with country Z with respect to the dividends because the shares of stock are not effectively connected with N's permanent establishment in the United States. Accordingly, assuming that there are no deductions connected with N's industrial or commercial profits, the tax for 1967, determined as provided in paragraph (c) of §1.871–12, is $46,900 as follows:

Tax on nontreaty income:	
$80,000 × .48	$38,400
Less $25,000 × .26	6,500
	31,900
Tax on treaty income:	
$100,000 (gross dividends) × .15	15,000
Total tax	46,900

Example 5. M, a corporation organized in foreign country Z, uses the calendar year as the taxable year. The United States and country Z are parties to an income tax convention which provides in part that a corporation of country Z is not subject to tax under Chapter 1 of the Code in respect of its commercial and industrial profits except such profits as are allocable to its permanent

establishment in the United States. The regulations in this chapter under the tax convention with country Z provide that a corporation of country Z having a permanent establishment in the United States is subject to U.S. tax upon its industrial and commercial profits from sources within the United States and that its industrial and commercial profits from such sources are deemed to be allocable to the permanent establishment in the United States. During 1967, M is engaged in a business (business A) in the United States which is carried on through a permanent establishment in the United States; in addition, M is engaged in a business (business B) in foreign country X and none of such business is carried on in the United States. During 1967, M receives from sources within the United States $40,000 in sales income through the operation of business A and $10,000 in sales income through the operation of business B, both of which amounts are, under section 864(c)(3) and §1.864–4(b), effectively connected for that year with the conduct of a trade or business in the United States by that corporation. The sales income is considered to be industrial and commercial profits under the tax convention with country Z. Since M has no income for 1967 which is not effectively connected for that year with the conduct of a trade or business in the United States by that corporation, section 894(b) and this paragraph do not apply. Accordingly, for 1967 M's entire income of $50,000 from sources within the United States is subject to tax, after allowance of deductions, in accordance with section 882(a)(1) and paragraph (b)(2) of §1.882–1.

(c)(1) *Substitute interest and dividend payments.* The provisions of an income tax convention dealing with interest or dividends paid to or derived by a foreign person include substitute interest or dividend payments that have the same character as interest or dividends under §1.864–5(b)92)(ii), 1.871–7(b)(2) or 1.881–2(b)(2). The provisions of this paragraph (c) shall apply for purposes of securities lending transactions or sale-repurchase transactions as defined in §1.861–2(a)(7) and §1.861–3(a)(6).

(2) *Dividend equivalents.* The provisions of an income tax convention relating to dividends paid to or derived by a foreign person apply to the payment of a dividend equivalent described in section 871(m) and the regulations thereunder.

(d) *Special rule for items of income received by entities*—(1) *In general.* The tax imposed by sections 871(a), 881(a), 1443, 1461, and 4948(a) on an item of income received by an entity, wherever organized, that is fiscally transparent under the laws of the United States and/or any other jurisdiction with respect to an item of income shall be eligible for reduction under the terms of an income tax treaty to which the United States is a party only if the item of income is derived by a resident of the applicable treaty jurisdiction. For this purpose, an item of income may be derived by either the entity receiving the item of income or by the interest holders in the entity or, in certain circumstances, both. An item of income paid to an entity shall be considered to be derived by the entity only if the entity is not fiscally transparent under the laws of the entity's jurisdiction, as defined in paragraph (d)(3)(ii) of this section, with respect to the item of income. An item of income paid to an entity shall be considered to be derived by the interest holder in the entity only if the interest holder is not fiscally transparent in its jurisdiction with respect to the item of income and if the entity is considered to be fiscally transparent under the laws of the interest holder's jurisdiction with respect to the item of income, as defined in paragraph (d)(3)(iii) of this section. Notwithstanding the preceding two sentences, an item of income paid directly to a type of entity specifically identified in a treaty as a resident of a treaty jurisdiction shall be treated as derived by a resident of that treaty jurisdiction.

(2) *Application to domestic reverse hybrid entities*—(i) *In general.* An income tax treaty may not apply to reduce the amount of federal income tax on U.S. source payments received by a domestic reverse hybrid entity. Further, notwithstanding paragraph (d)(1) of this section, the foreign interest holders of a domestic reverse hybrid entity are not entitled to the benefits of a reduction of U.S. income tax under an income tax treaty on items of income received from U.S. sources by such entity. A domestic reverse hybrid entity is a domestic entity that is treated as not fiscally transparent for U.S. tax purposes and as fiscally transparent under the laws of the interest holder's jurisdiction, with respect to the item of income received by the domestic entity.

(ii) *Payments by domestic reverse hybrid entities—(A) General rule.* Except as otherwise provided in paragraph (d)(2)(ii)(B) of this section, an item of income paid by a domestic reverse hybrid entity to an interest holder in such entity shall have the character of such item of income under U.S. law and shall be considered to be derived by the interest holder, provided the interest holder is not fiscally transparent in its jurisdiction, as defined in paragraph (d)(3)(iii) of this section, with respect to the item of income. In determining whether the interest holder is fiscally transparent with respect to the item of income under this paragraph (d)(2)(ii)(A), the determination under paragraph (d)(3)(ii) of this section shall be made based on the treatment that would have resulted had the item of income been paid by an entity that is not fiscally transparent under the laws of the interest holder's jurisdiction with respect to any item of income.

(B) *Payment made to related foreign interest holder—(1) General rule.* If—

(*i*) A domestic entity makes a payment to a related domestic reverse hybrid entity that is treated as a dividend under either the laws of the United States or the laws of the jurisdiction of a related foreign interest holder in the domestic reverse hybrid entity, and under the laws of the jurisdiction of the related foreign interest holder in the domestic reverse hybrid entity, the related foreign interest holder is treated as deriving its proportionate share of the payment under the principles of paragraph (d)(1) of this section; and

(*ii*) The domestic reverse hybrid entity makes a payment of a type that is deductible for U.S. tax purposes to the related foreign interest holder or to a person, wherever organized, the income and losses of which are available, under the laws of the jurisdiction of the related foreign interest holder, to offset the income and losses of the related foreign interest holder, and for which a reduction in U.S. withholding tax would be allowed under an applicable income tax treaty; then

(*iii*) To the extent the amount of the payment described in paragraph (d)(2)(ii)(B)(*1*)(*ii*) of this section does not exceed the sum of the portion of the payment described in paragraph (d)(2)(ii)(B)(*1*)(*i*) of this section treated as derived by the related foreign interest holder and the portion of any other prior payments described in paragraph (d)(2)(ii)(B)(*1*)(*i*) of this section treated as derived by the related foreign interest holder, the amount of the payment described in (d)(2)(ii)(B)(*1*)(*ii*) of this section will be treated for all purposes of the Internal Revenue Code and any applicable income tax treaty as a distribution within the meaning of section 301(a) of the Internal Revenue Code, and the tax to be withheld from the payment described in paragraph (d)(2)(ii)(B)(*1*)(*ii*) of this section (assuming the payment is a dividend under section 301(c)(1) of the Internal Revenue Code) shall be determined based on the appropriate rate of withholding that would be applicable to dividends paid from the domestic reverse hybrid entity to the related foreign interest holder in accordance with the principles of paragraph (d)(2)(ii)(A) of this section.

(*2*) *Determining amount to be recharacterized under paragraph (d)(2)(ii)(B)(1)(iii).* For purposes of determining the amount to be recharacterized under paragraph (d)(2)(ii)(B)(*1*)(*iii*) of this section, the portion of the payment described in paragraph (d)(2)(ii)(B)(*1*)(*i*) of this section treated as derived by the related foreign interest holder shall be increased by the portion of the payment derived by any other person described in paragraph (d)(2)(ii)(B)(*1*)(*ii*), and shall be reduced by the amount of any prior section 301(c) distributions made by the domestic reverse hybrid entity to the related foreign interest holder or any other person described in paragraph (d)(2)(ii)(B)(*1*)(*ii*) and by the amount of any payments from the domestic reverse hybrid entity previously recharacterized under paragraph (d)(2)(ii)(B)(*1*)(*iii*) of this section.

(*3*) *Tiered entities.* The principles of this paragraph (d)(2)(ii)(B) also shall apply to payments referred to in this paragraph (d)(2)(ii)(B) made among related entities when there is more than one domestic reverse hybrid entity or other fiscally transparent entity involved.

(*4*) *Definition of related.* For purposes of this section, a person shall be treated as related to a domestic reverse hybrid entity if it is related by reason of the ownership requirements of section 267(b) or 707(b)(1), except that the language ''at least 80 percent'' applies instead of ''more than 50 percent,'' where applicable. For purposes of determining whether a person is related by reason of the ownership requirements of section 267(b) or 707(b)(1), the constructive ownership rules of section 318 shall apply, and the attribution rules of section 267(c) also shall apply to the extent they attribute ownership to persons to whom section 318 does not attribute ownership.

(C) *Payments to persons not described in paragraph* (d)(2)(ii)(B)(1)(ii)—(1) *Related persons.* The Commissioner may treat a payment by a domestic reverse hybrid entity to a related person (who is neither the related foreign interest holder nor otherwise described in paragraph (d)(2)(ii)(B)(*1*)(*ii*) of this section), in whole or in part, as being made to a related foreign interest holder for purposes of applying paragraph (d)(2)(ii)(B) of this section, if—

(i) The payment to the related person is of a type that is deductible by the domestic reverse hybrid entity; and

(*ii*) The payment is made in connection with one or more transactions the effect of which is to avoid the application of paragraph (d)(2)(ii)(B) of this section.

(*2*) *Unrelated persons.* The Commissioner may treat a payment by a domestic reverse hybrid entity to an unrelated person, in whole or in part, as being made to a related foreign interest holder for purposes of applying paragraph (d)(2)(ii)(B) of this section, if—

(*i*) The payment to the unrelated person is of a type that is deductible by the domestic reverse hybrid entity;

(*ii*) The unrelated person (or other person (whether related or not) which receives a payment in a series of transactions that includes a transaction involving such unrelated person) makes a payment to the related foreign interest holder (or other person described in paragraph (d)(2)(ii)(B)(*1*)(*ii*));

(*iii*) The foregoing payments are made in connection with a series of transactions which constitute a financing arrangement, as defined in §1.881–3(a)(2)(i); and

(*iv*) The transactions have the effect of avoiding the application of paragraph (d)(2)(ii)(B) of this section.

(iii) *Examples.* The rules of this paragraph (d)(2) are illustrated by the following examples:

Example 1. Dividend paid by unrelated entity to domestic reverse hybrid entity. (i) *Facts.* Entity A is a domestic reverse hybrid entity, as defined in paragraph (d)(2)(i) of this section, with respect to the U.S. source dividends it receives from B, a domestic corporation to which A is not related within the meaning of paragraph (d)(2)(ii)(B)(*4*) of this section. A's 85-percent shareholder, FC, is a corporation organized under the laws of Country X, which has an income tax treaty in effect with the United States. A's remaining 15-percent shareholder is an unrelated domestic corporation. Under Country X law, FC is not fiscally transparent with respect to the dividend, as defined in paragraph (d)(3)(ii) of this section. In year 1, A receives $100 of dividend income from B. Under Country X law, FC is treated as deriving $85 of the $100 dividend payment received by A. The applicable rate of tax on dividends under the U.S.-Country X income tax treaty is 5 percent with respect to a 10-percent or more corporate shareholder.

(ii) *Analysis.* Under paragraph (d)(2)(i) of this section, the U.S.-Country X income tax treaty does not apply to the dividend income received by A because the payment is made by B, a domestic corporation, to A, another domestic corporation. A remains fully taxable under the U.S. tax laws as a domestic corporation with regard to that item of income. Further, pursuant to paragraph (d)(2)(i) of this section, notwithstanding the fact that A is treated as fiscally transparent with respect to the dividend income under the laws of Country X, FC may not claim a reduced rate of taxation on its share of the U.S. source dividend income received by A.

Example 2. Interest paid by domestic reverse hybrid entity to related foreign interest holder where dividend is paid by unrelated entity. (i) *Facts.* The facts are the same as in *Example 1.* Both the United States and Country X characterize the payment by B in year 1 as a dividend. In addition, in year 2, A makes a payment of $25 to FC that is characterized under the Internal Revenue Code as interest on a loan from FC to A. Under the U.S.-Country X income tax treaty, the rate of tax on interest is zero. Under Country X laws, had the interest been paid by an entity that is not fiscally transparent under Country X's laws with respect to any item of income, FC would not be fiscally transparent as defined

in paragraph (d)(2)(ii) of this section with respect to the interest.

(ii) *Analysis.* The analysis is the same as in *Example 1* with respect to the $100 payment from B to A. With respect to the $25 payment from A to FC, paragraph (d)(2)(ii)(B) of this section will not apply because, although FC is a related foreign interest holder in A, A is not related to B, the payor of the dividend income it received. Under paragraph (d)(2)(ii)(A) of this section, the $25 of interest paid by A to FC in year 2 is characterized under U.S. law as interest. Accordingly, in year 2, A is entitled to an interest deduction with respect to the $25 interest payment from A to FC, and FC is entitled to the reduced rate of withholding applicable to interest under the U.S.-Country X income tax treaty, assuming all other requirements for claiming treaty benefits are met.

Example 3. Interest paid by domestic reverse hybrid entity to related foreign interest holder where dividend is paid by a related entity. (i) *Facts.* The facts are the same as in *Example 2,* except the $100 dividend income received by A in year 1 is from A's wholly-owned subsidiary, S.

(ii) *Analysis.* The analysis is the same as in *Example 1* with respect to the $100 dividend payment from S to A. However, the $25 interest payment in year 2 by A to FC will be treated as a dividend for all purposes of the Internal Revenue Code and the U.S.-Country X income tax treaty because $25 does not exceed FC's share of the $100 dividend payment made by S to A ($85). Since FC is not fiscally transparent with respect to the payment as determined under paragraph (d)(2)(ii)(A) of this section, FC is entitled to the reduced rate applicable to dividends under the U.S.-Country X income tax treaty with respect to the $25 payment. Because the $25 payment in year 2 is recharacterized as a dividend for all purposes of the Internal Revenue Code and the U.S.-Country X income tax treaty, A is not entitled to an interest deduction with respect to that payment and FC is not entitled to claim the reduced rate of withholding applicable to interest.

Example 4. Definition of related foreign interest holder. (i) *Facts.* The facts are the same as in *Example 3,* except that A has two 50-percent shareholders, FC1 and FC2. In year 2, A makes an interest payment of $25 to both FC1 and FC2. FC1 is a corporation organized under the laws of Country X, which has an income tax treaty in effect with the United States. FC2 is a corporation organized under the laws of Country Y, which also has an income tax treaty in effect with the United States. FP owns 100-percent of both FC1 and FC2, and is organized under the laws of Country X. Under Country X law, FC1 is not fiscally transparent with respect to the dividend, as defined in paragraph (d)(3)(ii) of this section. Under Country X law, FC1 is treated as deriving $50 of the $100 dividend payment received by A because A is fiscally transparent under the laws of Country X, as determined under paragraph (d)(3)(iii) of this section. The applicable rate of tax on dividends under the U.S.-Country X income tax treaty is 5-percent with respect to a 10-percent or more corporate shareholder. Under Country Y law, FC2 is not treated as deriving any of the $100 dividend payment received by A because, under the laws of Country Y, A is not a fiscally transparent entity.

(ii) *Analysis.* The analysis is the same as in *Example 1* with respect to the $100 dividend payment from S to A. With respect to the $25 payment in year 2 by A to FC1, the payment will be treated as a dividend for all purposes of the Internal Revenue Code and the U.S.-Country X income tax treaty because FC1 is a related foreign interest holder as determined under paragraph (d)(2)(ii)(B)(*4*) of this section, and because $25 does not exceed FC1's share of the dividend payment made by S to A ($50). FC1 is a related foreign interest holder because FC1 is treated as owning the stock of A owned by FC2 under section 267(b)(3). Since FC1 is not fiscally transparent with respect to the payment as determined under paragraph (d)(2)(ii)(A) of this section, FC1 is entitled to the 5-percent reduced rate applicable to dividends under the U.S.-Country X income tax treaty with respect to the $25 payment. Because the $25 payment in year 2 is recharacterized as a dividend for all purposes of the Internal Revenue Code and the U.S.-Country X income tax treaty, A is not entitled to an interest deduction with respect to that payment. Even though FC2 is also a related foreign interest holder, the $25 interest payment by A to FC2 in year 2 is not recharacterized because A is not fiscally transparent under the laws of Country Y, and FC2 is not treated as deriving any of the $100 dividend payment received by A. Thus, the U.S.-Country Y income tax treaty is not implicated.

Example 5. Higher treaty withholding rate on dividends. (i) *Facts.* The facts are the same as in *Example 3,* except that under the U.S.-Country X income tax treaty, the rate of tax on interest is 10-percent and the rate of tax on dividends is 5-percent.

(ii) *Analysis.* The analysis is the same as in *Example 1* with respect to the $100 dividend payment from S to A. The analysis is the same as in *Example 3* with respect to the $25 interest payment in year 2 from A to FC.

Example 6. Foreign sister corporation the income and losses of which may offset the income and losses of related foreign interest holder. (i) *Facts.* The facts are the same as *Example 3,* except that in year 2, A makes the interest payment of $25 to FS, a subsidiary of FC also organized in Country X. Under the laws of Country X, FS is not fiscally transparent with respect to the interest payment, and the income and losses of FS may be used to offset the income and losses of FC.

(ii) *Analysis*. The analysis is the same as in *Example 1* with respect to the $100 dividend payment from S to A. With respect to the $25 interest payment from A to FS in year 2, FS is a person described in paragraph (d)(2)(ii)(B)(*1*)(ii) of this section because the income and losses of FS may be used under the laws of Country X to offset the income and losses of FC, the related foreign interest holder that derived its proportionate share of the payment from S to A. Therefore, paragraph (d)(2)(ii)(B) of this section applies, and the $25 interest payment in year 2 by A to FS is treated as a dividend for all purposes of the Internal Revenue Code and the U.S.-Country X income tax treaty because the $25 payment does not exceed FC's share of the $100 dividend payment made by S to A ($85). Since FS is not fiscally transparent with respect to the payment as determined under paragraph (d)(2)(ii)(A) of this section, FS is entitled to obtain the rate applicable to dividends under the U.S.-Country X income tax treaty with respect to the $25 payment. Because the $25 payment in year 2 is recharacterized as a dividend for all purposes of the Internal Revenue Code and the U.S.-Country X income tax treaty, A is not entitled to an interest deduction with respect to the payment and FS is not entitled to claim the reduced rate of withholding applicable to interest under the U.S.-Country X income tax treaty.

Example 7. Interest paid by domestic reverse hybrid entity to unrelated foreign bank. (i) *Facts*. The facts are the same as in *Example 3*, except that in year 2, A makes the interest payment of $25 to FB, a Country Y unrelated foreign bank, on a loan from FB to A.

(ii) *Analysis*. The analysis is the same as in *Example 1* with respect to the $100 dividend payment from S to A. With respect to the payment from A to FB, paragraph (d)(2)(ii)(B) of this section will not apply because, although A is related to S, the payor of the dividend income it received, A is not related to FB under paragraph (d)(2)(ii)(B)(*4*) of this section. Under paragraph (d)(2)(ii)(A) of this section, the $25 interest payment made from A to FB in year 2 is characterized as interest under the Internal Revenue Code.

Example 8. Interest paid by domestic reverse hybrid to an unrelated entity pursuant to a financing arrangement. (i) *Facts*. The facts are the same as in *Example 7*, except that in year 3, FB makes an interest payment of $25 to FC on a deposit made by FC with FB.

(ii) *Analysis*. The analysis is the same as in *Example 1* with respect to the $100 dividend payment from S to A. With respect to the $25 payment from A to FB in year 2, because the payment is made in connection with a transaction that consititutes a financing arrangement within the meaning of paragraph (d)(2)(ii)(C)(*2*) of this section, the payment may be treated by the Commissioner as being made directly to FC. If the Commissioner disregards FB, then the analysis is the same as in *Example 3* with respect to the $25 interest payment in year 2 from A to FC.

Example 9. Royalty paid by related entity to domestic reverse hybrid entity. (i) *Facts*. The facts are the same as in *Example 3*, except the $100 income received by A from S in year 1 is a royalty payment under both the laws of the United States and the laws of Country X. The royalty rate under the treaty is 10 percent and the interest rate is 0 percent.

(ii) *Analysis*. The analysis as to the royalty payment from S to A is the same as in *Example 1* with respect to the $100 dividend payment from S to A. With respect to the $25 payment from A to FC, paragraph (d)(2)(ii)(B) of this section will not apply because the payment from S to A is not treated as a dividend under the Internal Revenue Code or the laws of Country X. Under paragraph (d)(2)(ii)(A) of this section, the $25 of interest paid by A to FC in year 2 is characterized as interest under the Internal Revenue Code. Accordingly, in year 2, FC may obtain the reduced rate of withholding applicable to interest under the U.S.-Country X income tax treaty, assuming all other requirements for claiming treaty benefits are met.

(3) *Definitions*—(i) *Entity*. For purposes of this paragraph (d), the term *entity* shall mean any person that is treated by the United States or the applicable treaty jurisdiction as other than an individual. The term *entity* includes disregarded entities, including single member disregarded entities with individual owners.

(ii) *Fiscally transparent under the law of the entity's jurisdiction*—(A) *General rule*. For purposes of this paragraph (d), an entity is fiscally transparent under the laws of the entity's jurisdiction with respect to an item of income to the extent that the laws of that jurisdiction require the interest holder in the entity, wherever resident, to separately take into account on a current basis the interest holder's respective share of the item of income paid to the entity, whether or not distributed to the interest holder, and the character and source of the item in the hands of the interest holder are determined as if such item were realized directly from the source from which realized by the entity. However, the entity will be fiscally transparent with respect to the item of income even if the item of income is not separately taken into account by the interest holder, provided the item of income, if separately taken

into account by the interest holder, would not result in an income tax liability for that interest holder different from that which would result if the interest holder did not take the item into account separately, and provided the interest holder is required to take into account on a current basis the interest holder's share of all such nonseparately stated items of income paid to the entity, whether or not distributed to the interest holder. In determining whether an entity is fiscally transparent with respect to an item of income in the entity's jurisdiction, it is irrelevant that, under the laws of the entity's jurisdiction, the entity is permitted to exclude such item from gross income or that the entity is required to include such item in gross income but is entitled to a deduction for distributions to its interest holders.

(B) *Special definitions.* For purposes of this paragraph (d)(3)(ii), an entity's jurisdiction is the jurisdiction where the entity is organized or incorporated or may otherwise be considered a resident under the laws of that jurisdiction. An interest holder will be treated as taking into account that person's share of income paid to an entity on a current basis even if such amount is taken into account by the interest holder in a taxable year other than the taxable year of the entity if the difference is due solely to differing taxable years.

(iii) *Fiscally transparent under the law of an interest holder's jurisdiction*—(A) *General rule.* For purposes of this paragraph (d), an entity is treated as fiscally transparent under the law of an interest holder's jurisdiction with respect to an item of income to the extent that the laws of the interest holder's jurisdiction require the interest holder resident in that jurisdiction to separately take into account on a current basis the interest holder's respective share of the item of income paid to the entity, whether or not distributed to the interest holder, and the character and source of the item in the hands of the interest holder are determined as if such item were realized directly from the source from which realized by the entity. However, an entity will be fiscally transparent with respect to the item of income even if the item of income is not separately taken into account by the interest holder, provided the item of income, if separately taken into account by the interest holder, would not result in an income tax liability for that interest holder different from that which would result if the interest holder did not take the item into account separately, and provided the interest holder is required to take into account on a current basis the interest holder's share of all such nonseparately stated items of income paid to the entity, whether or not distributed to the interest holder. An entity will not be treated as fiscally transparent with respect to an item of income under the laws of the interest holder's jurisdiction, however, if, under the laws of the interest holder's jurisdiction, the interest holder in the entity is required to include in gross income a share of all or a part of the entity's income on a current basis year under any type of anti-deferral or comparable mechanism. In determining whether an entity is fiscally transparent with respect to an item of income under the laws of an interest holder's jurisdiction, it is irrelevant how the entity is treated under the laws of the entity's jurisdiction.

(B) *Special definitions.* For purposes of this paragraph (d)(3)(iii), an interest holder's jurisdiction is the jurisdiction where the interest holder is organized or incorporated or may otherwise be considered a resident under the laws of that jurisdiction. An interest holder will be treated as taking into account that person's share of income paid to an entity on a current basis even if such amount is taken into account by such person in a taxable year other than the taxable year of the entity if the difference is due solely to differing taxable years.

(iv) *Applicable treaty jurisdiction.* The term *applicable treaty jurisdiction* means the jurisdiction whose income tax treaty with the United States is invoked for purposes of reducing the rate of tax imposed under sections 871(a), 881(a), 1461, and 4948(a).

(v) *Resident.* The term *resident* shall have the meaning assigned to such term in the applicable income tax treaty.

(4) *Application to all income tax treaties.* Unless otherwise explicitly agreed

upon in the text of an income tax treaty, the rules contained in this paragraph (d) shall apply in respect of all income tax treaties to which the United States is a party. Notwithstanding the foregoing sentence, the competent authorities may agree on a mutual basis to depart from the rules contained in this paragraph (d) in appropriate circumstances. However, a reduced rate under a tax treaty for an item of U.S. source income paid will not be available irrespective of the provisions in this paragraph (d) to the extent that the applicable treaty jurisdiction would not grant a reduced rate under the tax treaty to a U.S. resident in similar circumstances, as evidenced by a mutual agreement between the relevant competent authorities or by a public notice of the treaty jurisdiction. The Internal Revenue Service shall announce the terms of any such mutual agreement or public notice of the treaty jurisdiction. Any denial of tax treaty benefits as a consequence of such a mutual agreement or notice shall affect only payment of U.S. source items of income made after announcement of the terms of the agreement or of the notice.

(5) *Examples*. This paragraph (d) is illustrated by the following examples:

Example 1. Treatment of entity treated as partnership by U.S. and country of organization. (i) *Facts*. Entity A is a business organization formed under the laws of Country X that has an income tax treaty in effect with the United States. A is treated as a partnership for U.S. federal income tax purposes. A is also treated as a partnership under the laws of Country X, and therefore Country X requires the interest holders in A to separately take into account on a current basis their respective shares of the items of income paid to A, whether or not distributed to the interest holders, and the character and source of the items in the hands of the interest holders are determined as if such items were realized directly from the source from which realized by A. A receives royalty income from U.S. sources that is not effectively connected with the conduct of a trade or business in the United States.

(ii) *Analysis*. A is fiscally transparent in its jurisdiction within the meaning of paragraph (d)(3)(ii) of this section with respect to the U.S. source royalty income in Country X and, thus, A does not derive such income for purposes of the U.S.-X income tax treaty.

Example 2. Treatment of interest holders in entity treated as partnership by U.S. and country of organization. (i) *Facts*. The facts are the same as under *Example 1*. A's partners are M, a corporation organized under the laws of Country Y that has an income tax treaty in effect with the United States, and T, a corporation organized under the laws of Country Z that has an income tax treaty in effect with the United States. M and T are not fiscally transparent under the laws of their respective countries of incorporation. Country Y requires M to separately take into account on a current basis M's respective share of the items of income paid to A, whether or not distributed to M, and the character and source of the items of income in M's hands are determined as if such items were realized directly from the source from which realized by A. Country Z treats A as a corporation and does not require T to take its share of A's income into account on a current basis whether or not distributed.

(ii) *Analysis*. M is treated as deriving its share of the U.S. source royalty income for purposes of the U.S.-Y income tax treaty because A is fiscally transparent under paragraph (d)(3)(iii) with respect to that income under the laws of Country Y. Under Country Z law, however, because T is not required to take into account its share of the U.S. source royalty income received by A on a current basis whether or not distributed, A is not treated as fiscally transparent. Accordingly, T is not treated as deriving its share of the U.S. source royalty income for purposes of the U.S.-Z income tax treaty.

Example 3. Dual benefits to entity and interest holder. (i) *Facts*. The facts are the same as under *Example 2*, except that A is taxable as a corporation under the laws of Country X. Article 12 of the U.S.-X income tax treaty provides for a source country reduced rate of taxation on royalties of 5-percent. Article 12 of the U.S.-Y income tax treaty provides that royalty income may only be taxed by the beneficial owner's country of residence.

(ii) *Analysis*. A is treated as deriving the U.S. source royalty income for purposes of the U.S.-X income tax treaty because it is not fiscally transparent with respect to the item of income within the meaning of paragraph (d)(3)(ii) of this section in Country X, its country of organization. M is also treated as deriving its share of the U.S. source royalty income for purposes of the U.S.-Y income tax treaty because A is fiscally transparent under paragraph (d)(3)(iii) of this section with respect to that income under the laws of Country Y. T is not treated as deriving the U.S. source royalty income for purposes of the U.S.-Z income tax treaty because under Country Z law A is not fiscally transparent. Assuming all other requirements for eligibility for treaty benefits have been satisfied, A is entitled to the 5-percent treaty reduced rate on royalties under the U.S.-X income tax treaty with respect to the entire royalty payment. Assuming all other

requirements for treaty benefits have been satisfied, M is also entitled to a zero rate under the U.S.-Y income tax treaty with respect to its share of the royalty income.

Example 4. Treatment of grantor trust. (i) *Facts.* Entity A is a trust organized under the laws of Country X, which does not have an income tax treaty in effect with the United States. M, the grantor and owner of A for U.S. income tax purposes, is a resident of Country Y, which has an income tax treaty in effect with the United States. M is also treated as the grantor and owner of the trust under the laws of Country Y. Thus, Country Y requires M to take into account all items of A's income in the taxable year, whether or not distributed to M, and determines the character of each item in M's hands as if such item was realized directly from the source from which realized by A. Country X does not treat M as the owner of A and does not require M to account for A's income on a current basis whether or not distributed to M. A receives interest income from U.S. sources that is neither portfolio interest nor effectively connected with the conduct of a trade or business in the United States.

(ii) *Analysis.* A is not fiscally transparent under the laws of Country X within the meaning of paragraph (d)(3)(ii) of this section with respect to the U.S. source interest income, but A may not claim treaty benefits because there is no U.S.-X income tax treaty. M, however, does derive the income for purposes of the U.S.-Y income tax treaty because under the laws of Country Y, A is fiscally transparent.

Example 5. Treatment of complex trust. (i) *Facts.* The facts are the same as in *Example 4* except that M is treated as the owner of the trust only under U.S. tax law, after application of section 672(f), but not under the law of Country Y. Although the trust document governing A does not require that A distribute any of its income on a current basis, some distributions are made currently to M. There is no requirement under Country Y law that M take into account A's income on a current basis whether or not distributed to him in that year. Under the laws of Country Y, with respect to current distributions, the character of the item of income in the hands of the interest holder is determined as if such item were realized directly from the source from which realized by A. Accordingly, upon a current distribution of interest income to M, the interest income retains its source as U.S. source income.

(ii) *Analysis.* M does not derive the U.S. source interest income because A is not fiscally transparent under paragraph (d)(3)(ii) of this section with respect to the U.S. source interest income under the laws of Country Y. Although the character of the interest in the hands of M is determined as if realized directly from the source from which realized by A, under the laws of Country Y, M is not required to take into account his share of A's interest income on a current basis whether or not distributed. Accordingly, neither A nor M is entitled to claim treaty benefits, since A is a resident of a non-treaty jurisdiction and M does not derive the U.S. source interest income for purposes of the U.S.-Y income tax treaty.

Example 6. Treatment of interest holders required to include passive income under anti-deferral regime. (i) *Facts.* The facts are the same as under *Example 2*. However, Country Z does require T, who is treated as owning 60-percent of the stock of A, to take into account its respective share of the royalty income of A under an anti-deferral regime applicable to certain passive income of controlled foreign corporations.

(ii) *Analysis.* T is still not eligible to claim treaty benefits with respect to the royalty income. T is not treated as deriving the U.S. source royalty income for purposes of the U.S.-Z income tax treaty under paragraph (d)(3)(iii) of this section because T is only required to take into account its pro rata share of the U.S. source royalty income by reason of Country Z's anti-deferral regime.

Example 7. Treatment of contractual arrangements operating as collective investment vehicles. (i) *Facts.* A is a contractual arrangement without legal personality for all purposes under the laws of Country X providing for joint ownership of securities. Country X has an income tax treaty in effect with the United States. A is a collective investment fund which is of a type known as a Common Fund under Country X law. Because of the absence of legal personality in Country X of the arrangement, A is not liable to tax as a person at the entity level in Country X and is thus not a resident within the meaning of the Residence Article of the U.S.-X income tax treaty. A is treated as a partnership for U.S. income tax purposes and receives U.S. source dividend income. Under the laws of Country X, however, investors in A only take into account their respective share of A's income upon distribution from the Common Fund. Some of A's interest holders are residents of Country X and some of Country Y. Country Y has no income tax treaty in effect with the United States.

(ii) *Analysis.* A is not fiscally transparent under paragraph (d)(3)(ii) of this section with respect to the U.S. source dividend income because the interest holders in A are not required to take into account their respective shares of such income in the taxable year whether or not distributed. Because A is an arrangement without a legal personality that is not considered a person in Country X and thus not a resident of Country X under the Residence Article of the U.S.-X income tax treaty, however, A does not derive the income as a resident of Country X for purposes of the U.S.-X income tax treaty. Further, because A is not fiscally transparent

under paragraph (d)(3)(iii) of this section with respect to the U.S. source dividend income, A's interest holders that are residents of Country X do not derive the income as residents of Country X for purposes of the U.S.-X income tax treaty.

Example 8. Treatment of person specifically listed as resident in applicable treaty. (i) *Facts.* The facts are the same as in *Example 7* except that A (the Common Fund) is organized in Country Z and the Residence Article of the U.S.-Z income tax treaty provides that ''the term 'resident of a Contracting State' includes, in the case of Country Z, Common Funds.* * *''

(ii) *Analysis.* A is treated, for purposes of the U.S.-Z income tax treaty as deriving the dividend income as a resident of Country Z under paragraph (d)(1) of this section because the item of income is paid directly to A, A is a Common Fund under the laws of Country Z, and Common Funds are specifically identified as residents of Country Z in the U.S.-Z treaty. There is no need to determine whether A meets the definition of fiscally transparent under paragraph (d)(3)(ii) of this section.

Example 9. Treatment of investment company when entity receives distribution deductions, and all distributions sourced by residence of entity. (i) *Facts.* Entity A is a business organization formed under the laws of Country X, which has an income tax treaty in effect with the United States. A is treated as a partnership for U.S. income tax purposes. Under the laws of Country X, A is an investment company taxable at the entity level and a resident of Country X. It is also entitled to a distribution deduction for amounts distributed to its interest holders on a current basis. A distributes all its net income on a current basis to its interest holders and, thus, in fact, has no income tax liability to Country X. A receives U.S. source dividend income. Under Country X law, all amounts distributed to interest holders of this type of business entity are treated as dividends from sources within Country X and Country X imposes a withholding tax on all payments by A to foreign persons. Under Country X laws, the interest holders in A do not have to separately take into account their respective shares of A's income on a current basis if such income is not, in fact, distributed.

(ii) *Analysis.* A is not fiscally transparent under paragraph (d)(3)(ii) of this section with respect to the U.S. source dividends because the interest holders in A do not have to take into account their respective share of the U.S. source dividends on a current basis whether or not distributed. A is also not fiscally transparent under paragraph (d)(3)(ii) of this section because there is a change in source of the income received by A when A distributes the income to its interest holders and, thus, the character and source of the income in the hands of A's interest holder are not determined as if such income were realized directly from the source from which realized by A. Accordingly, A is treated as deriving the U.S. source dividends for purposes of the U.S.-Country X treaty.

Example 10. Item by item determination of fiscal transparency. (i) *Facts.* Entity A is a business organization formed under the laws of Country X, which has an income tax treaty in effect with the United States. A is treated as a partnership for U.S. income tax purposes. Under the laws of Country X, A is an investment company taxable at the entity level and a resident of Country X. It is also entitled to a distribution deduction for amounts distributed to its interest holders on a current basis. A receives both U.S. source dividend income and interest income from U.S. sources that is neither portfolio interest nor effectively connected with the conduct of a trade or business in the United States. Country X law sources all distributions attributable to dividend income based on the residence of the investment company. In contrast, Country X law sources all distributions attributable to interest income based on the residence of the payor of the interest. No withholding applies with respect to distributions attributable to U.S. source interest and the character of the distributions attributable to the interest income remains the same in the hands of A's interest holders as if such items were realized directly from the source from which realized by A. However, under Country X law the interest holders in A do not have to take into account their respective share of the interest income received by A on a current basis whether or not distributed.

(ii) *Analysis.* An item by item analysis is required under paragraph (d) of this section. The analysis is the same as *Example 9* with respect to the dividend income. A is also not fiscally transparent under paragraph (d)(3)(ii) of this section with respect to the interest income because, although the character of the distributions attributable to the interest income in the hands of A's interest holders is determined as if realized directly from the source from which realized by A, under Country X law the interest holders in A do not have to take into account their respective share of the interest income received by A on a current basis whether or not distributed. Accordingly, A derives the U.S. source interest income for purpose of the U.S.-X treaty.

Example 11. Treatment of charitable organizations. (i) *Facts.* Entity A is a corporation organized under the laws of Country X that has an income tax treaty in effect with the United States. Entity A is established and operated exclusively for religious, charitable, scientific, artistic, cultural, or educational purposes. Entity A receives U.S. source dividend income from U.S. sources. A

provision of Country X law generally exempts Entity A's income from Country X tax due to the fact that Entity A is established and operated exclusively for religious, charitable, scientific, artistic, cultural, or educational purposes. But for such provision, Entity A's income would be taxed by Country X.

(ii) *Analysis.* Entity A is not fiscally transparent under paragraph (d)(3)(ii) of this section with respect to the U.S. source dividend income because, under Country X law, the dividend income is treated as an item of income of A and no other persons are required to take into account their respective share of the item of income on a current basis, whether or not distributed. Accordingly, Entity A is treated as deriving the U.S. source dividend income.

Example 12. Treatment of pension trusts. (i) *Facts.* Entity A is a trust established and operated in Country X exclusively to provide pension or other similar benefits to employees pursuant to a plan. Entity A receives U.S. source dividend income. A provision of Country X law generally exempts Entity A's income from Country X tax due to the fact that Entity A is established and operated exclusively to provide pension or other similar benefits to employees pursuant to a plan. Under the laws of Country X, the beneficiaries of the trust are not required to take into account their respective share of A's income on a current basis, whether or not distributed and the character and source of the income in the hands of A's interest holders are not determined as if realized directly from the source from which realized by A.

(ii) *Analysis.* A is not fiscally transparent under paragraph (d)(3)(ii) of this section with respect to the U.S. source dividend income because under the laws of Country X, the beneficiaries of A are not required to take into account their respective share of A's income on a current basis, whether or not distributed. A is also not fiscally transparent under paragraph (d)(3)(ii) of this section with respect to the U.S. source dividend income because under the laws of Country X, the character and source of the income in the hands of A's interest holders are not determined as if realized directly from the source from which realized by A. Accordingly, A derives the U.S. source dividend income for purposes of the U.S.-X income tax treaty.

(6) *Effective dates.* This paragraph (d) applies to items of income paid on or after June 30, 2000, except paragraphs (d)(2)(ii) and (d)(2)(iii) of this section apply to items of income paid by a domestic reverse hybrid entity on or after June 12, 2002 with respect to amounts received by the domestic reverse hybrid entity on or after June 12, 2002.

(e) *Effective/applicability date.* Paragraphs (a) and (b) of this section apply for taxable years beginning after December 31, 1966. For corresponding rules applicable to taxable years beginning before January 1, 1967, (see 26 CFR part 1 revised April 1, 1971). Paragraph (c)(1) of this section applies to payments made after November 13, 1997. Paragraph (c)(2) of this section applies to payments made on or after December 5, 2013. See paragraph (d)(6) of this section for applicability dates for paragraph (d) of this section.

[T.D. 7293, 38 FR 32800, Nov. 28, 1973, as amended by T.D. 8735, 62 FR 53502, Oct. 14, 1997; T.D. 8889, 65 FR 40997, July 3, 2000; 65 FR 76932, Dec. 8, 2000; T.D. 8999, 67 FR 40160, June 12, 2002; T.D. 9648, 78 FR 73080, Dec. 5, 2013]

§ 1.895–1 Income derived by a foreign central bank of issue, or by Bank for International Settlements, from obligations of the United States or from bank deposits.

(a) *In general.* Income derived by a foreign central bank of issue from obligations of the United States or of any agency or instrumentality thereof, or from interest on deposits with persons carrying on the banking business, is excluded from the gross income of such bank and is exempt from income tax if the bank is the owner of the obligations or deposits and does not hold the obligations or deposits for, or use them in connection with, the conduct of a commercial banking function or other commercial activity by such bank. For purposes of this section and paragraph (i) of § 1.1441–4, obligations of the United States or of any agency or instrumentality thereof include beneficial interests, participations, and other instruments issued under section 302(c) of the Federal National Mortgage Association Charter Act (12 U.S.C. 1717). See 24 CFR part 1600 *et seq.*

(b) *Foreign central bank of issue.* (1) A foreign central bank of issue is a bank which is by law or government sanction the principal authority, other than the government itself, issuing instruments intended to circulate as currency. Such a bank is generally the custodian of the banking reserves of the country under whose law it is organized. See also paragraph (b)(5) of § 1.861–2.

(2) The exclusion granted by section 895 applies to an instrumentality that is separate from a foreign government, whether or not owned in whole or in part by a foreign government. For example, foreign banks organized along the lines of, and performing functions similar to, the Federal Reserve System qualify as foreign central banks of issue for purposes of this section.

(3) The Bank for International Settlements shall be treated as though it were a foreign central bank of issue for purposes of obtaining the exclusion granted by section 895.

(c) *Ownership of United States obligations or bank deposits.* The exclusion does not apply if the obligations or bank deposits from which the income is derived are not owned by the foreign central bank of issue. Obligations held, or deposits made, by a foreign central bank of issue as agent, custodian, trustee, or in any other fiduciary capacity, shall be considered as not owned by such bank for purposes of this section.

(d) *Commercial banking function or other commercial activity.* The exclusion applies only to obligations of the United States or of any agency or instrumentality thereof, or to bank deposits, held for, or used in connection with, the conduct of a central banking function and not to obligations or deposits held for, or used in connection with, the conduct of commercial banking functions or other commercial activities by the foreign central bank.

(e) *Other exclusions.* See section 861(a)(1) (A) and (E) and §1.861–2(b) (1) and (4), for special rules relating to interest paid or credited before January 1, 1977, on deposits and on similar amounts and for rules on interest derived from bankers' acceptances. For exemption from withholding under §1.1441–1 on income derived by a foreign central bank of issue, or by the Bank of International Settlements, from obligations of the United States or of any agency or instrumentality thereof, or from bank deposits, see §1.1441–4(i).

(f) *Effective date.* This section shall apply with respect to taxable years beginning after December 31, 1966. For corresponding rules applicable to taxable years beginning before January 1, 1967, see 26 CFR 1.85–1 (Revised as of January 1, 1972).

[T.D. 7378, 40 FR 45435, Oct. 2, 1975; 40 FR 48508, Oct. 16, 1975]

§1.897–1 Taxation of foreign investment in United States real property interests, definition of terms.

(a) *In general*—(1) *Purpose and scope of regulations.* These regulations provide guidance with respect to the taxation of foreign investments in U.S. real property interests and related matters. This section defines various terms for purposes of sections 897, 1445, and 6039C and the regulations thereunder. Section 1.897–2 provides rules regarding the definition of, and consequences of, U.S. real property holding corporation status. Section 1.897–3 sets forth rules pursuant to which certain foreign corporations may elect under section 897(i) to be treated as domestic corporations for purposes of sections 897 and 6039C. Finally, §1.987–4 provides rules concerning the similar election under section 897(k) for certain foreign corporations in the process of liquidation.

(2) *Effective date.* The regulations set forth in §§1.897–1 through 1.897–4 are effective for transactions occurring after June 18, 1980. However, with respect to all transactions occurring after June 18, 1980 and before January 30, 1985, taxpayers may at their option choose to apply the Temporary Regulations under section 897 (in their entirety). The Temporary Regulations are located at 26 CFR 6a.897–1 through 6a.897–4 (Revised as of April 1, 1983), and were originally published in the FEDERAL REGISTER for September 21, 1982 (47 FR 41532) and amended by T.D. 7890, published in the FEDERAL REGISTER on April 28, 1983 (48 FR 19163).

(b) *Real property*—(1) *In general.* The term ''real property'' includes the following three categories of property: Land and unserved natural products of the land, improvements, and personal property associated with the use of real property. The three categories of real property are defined in subparagraphs (2), (3), and (4) of this paragraph (b). Local law definitions will not be controlling for purposes of determining the meaning of the term ''real property'' as it is used in sections 897, 1445,

and 6039C and the regulations thereunder.

(2) *Land and unserved natural products of the land.* The term ''real property'' includes land, growing crops and timber, and mines, wells, and other natural deposits. Crops and timber cease to be real property at the time that they are served from the land. Ores, minerals, and other natural deposits cease to be real property when they are extracted from the ground. The storage of severed or extracted crops, timber, or minerals in or upon real property will not cause such property to be recharacterized as real property.

(3) *Improvements*—(i) *In general.* The term ''real property'' includes improvements on land. An improvement is a building, any other inherently permanent structure, or the structural components of either, as defined in subdivisions (ii) through (iv) of this paragraph (b)(3).

(ii) *Building.* The term ''building'' generally means any structure or edifice enclosing a space within its walls, and usually covered by a roof, the purpose of which is, for example, to provide shelter or housing or to provide working, office, parking, display, or sales space. The term includes, for example, structures such as apartment houses, factory and office buildings, warehouses, barns, garages, railway or bus stations, and stores. Any structure that is classified as a building for purposes of section 48(a)(1)(B) and §1.48–1 shall be treated as such for purposes of this section.

(iii) *Inherently permanent structure*—(A) *In general.* The term ''inherently permanent structure'' means any property not otherwise described in this paragraph (b)(3) that is affixed to real property and that will ordinarily remain affixed for an indefinite period of time. Property that is not classified as a building for purposes of section 48(a)(1)(B) and §1.48–1 may nevertheless constitute an inherently permanent structure. For purposes of this section, affixation to real property may be accomplished by weight alone.

(B) *Use of precedents under section 48.* Any property not otherwise described in this paragraph (b)(3) that constitutes ''other tangible property'' under the principles of section 48(a)(1)(B) and §1.48–1 (c) and (d) shall be treated for purposes of this section as an inherently permanent structure. Thus, for example, the term includes swimming pools, paved parking areas and other pavements, special foundations for heavy equipment, wharves and docks, bridges, fences, inherently permanent advertising displays, inherently permanent outdoor lighting facilities, railroad tracks and signals, telephone poles, permanently installed telephone and television cables, broadcasting towers, oil derricks, oil and gas pipelines, oil and gas storage tanks, grain storage bins, and silos. However, property that is determined to be either property in the nature of machinery under §1.48–1(c) or property which is essentially an item of machinery or equipment under §1.48–1(e)(1)(i) shall not be treated as an inherently permanent structure.

(C) *Absence of precedents under section 48.* Where precedents developed under the principles of section 48 fail to provide adequate guidance with respect to the classification of particular property, the determination of whether such property constitutes an inherently permanent structure shall be made in view of all the facts and circumstances. In particular, the following factors must be taken into account:

(*1*) The manner in which the property is affixed to real property;

(*2*) Whether the property was designed to be easily removable or to remain in place indefinitely;

(*3*) Whether the property has been moved since its initial installation;

(*4*) Any circumstances that suggest the expected period of affixation (e.g., a lease that requires removal of the property upon its expiration);

(*5*) The amount of damage that removal of the property would cause to the property itself or to the real property to which it is affixed; and

(*6*) The extent of the effort that would be required to remove the property, in terms of time and expense.

(iv) *Structural components of buildings and other inherently permanent structures.* Structural components of buildings and other inherently permanent structures, as defined in §1.48–1 (e)(2), themselves constitute improvements.

Structural components include walls, partitions, floors, ceilings, windows, doors, wiring, plumbing, central heating and central air conditioning systems, lighting fixtures, pipes, ducts, elevators, escalators, sprinkler systems, fire escapes and other components relating to the operation or maintenance of a building. However, the term ''structural components'' does not include machinery the sole justification for the installation of which is the fact that such machinery is required to meet temperature or humidity requirements which are essential for the operation of other machinery or the processing of materials or foodstuffs. Machinery may meet the ''sole justification'' test provided by the preceding sentence even though it incidentally provides for the comfort of employees or serves to an insubstantial degree areas where such temperature or humidity requirements are not essential.

(4) *Personal property associated with the use of the real property*—(i) *In general*. The term ''real property'' includes movable walls, furnishings, and other personal property associated with the use of the real property. Personal property is associated with the use of real property only if it is described in one of the categories set forth in subdivisions (A) through (D) of this paragraph (b)(4)(i). ''Personal property'' for purposes of this section means any property that constitutes ''tangible personal property'' under the principles of § 1.48–1(c), without regard to whether such property qualifies as section 38 property. Such property will be associated with the use of the real property only where both the personal property and the United States real property interest with which it is associated are held by the same person or by related persons within the meaning of § 1.897–1(i). For purposes of this paragraph (b)(4)(i), property is used ''predominantly'' in a named activity if it is devoted to that activity during at least half of the time in which it is in use during a calendar year.

(A) *Property used in mining, farming, and forestry*. Personal property is associated with the use of real property if it is predominantly used to exploit unsevered natural products in or upon the land. Such property includes mining equipment used to extract ores, minerals, and other natural deposits from the ground. It also includes any property used to cultivate the soil and harvest its products, such as farm machinery, draft animals, and equipment used in the growing and cutting of timber. However, personal property used to process or transport minerals, crops, or timber after they are severed from the land is not associated personal property.

(B) *Property used in the improvement of real property*. Personal property is associated with the use of real property if it is predominantly used to construct or otherwise carry out improvements to real property. Such property includes equipment used to alter the natural contours of the land, equipment used to clear and prepare raw land for construction, and equipment used to carry out the construction of improvements.

(C) *Property used in the operation of a lodging facility*. Personal property is associated with the use of real property if it is predominantly used in connection with the operation of a lodging facility. Property that is used in connection with the operation of a lodging facility includes property used in the living quarters of such facility, such as beds and other furniture, refrigerators, ranges and other equipment, as well as property used in the common areas of such facility, such as lobby furniture and laundry equipment. Such property constitutes personal property associated with the use of real property in the hands of the owner or operator of the facility, not of the tenant or guest. A lodging facility is an apartment house or apartment, hotel, motel, dormitory, residence, or any other facility (or part of a facility) predominantly used to provide, at a charge, living and/or sleeping accommodations, whether on daily, weekly, monthly, annual, or other basis. The term ''lodging facility'' does not include a personal residence occupied solely by its owner, or a facility used primarily as a means of transportation (such as an aircraft, vessel, or a railroad car) or used primarily to provide medical or convalescent services, even though sleeping accommodations are provided. Nor does

the term include temporary living quarters provided by an employer due to the unavailability of lodgings within a reasonable distance of a work-site (such as a mine or construction project). The term ''lodging facility'' does not include any portion of a facility that constitutes a nonlodging commercial facility and that is available to persons not using the lodging facility on the same basis that it is available to tenants of the lodging facility. Examples of nonlodging commercial facilities include restaurants, drug stores, and grocery stores located in a lodging facility.

(D) *Property used in the rental of furnished office and other work space.* Personal property is associated with the use of real property if it is predominantly used by a lessor to provide furnished office or other work space to lessees. Property that is so used includes office furniture and equipment included in the rental of furnished space. Such property constitutes personal property associated with the use of real property in the hands of the lessor, not of the lessee.

(ii) *Dispositions of associated personal property*—(A) *In general.* Personal property that has become associated with the use of a real property interest shall itself be treated as a real property interest upon its disposition, unless either:

(*1*) The personal property is disposed of more than one year before the disposition of any present right to use or occupy the real property with which it was associated (and subject to the provisions of subdivision (B) of this paragraph (b)(4)(ii));

(*2*) The personal property is disposed of more than one year after the disposition of all present rights to use or occupy the real property with which it was associated (and subject to the provisions of subdivision (C) of this paragraph (b)(4)(ii)); or

(*3*) The personal property and the real property with which it was associated are separately sold to persons that are related neither to the transferor nor to one another (and subject to the provisions of subdivision (D) of this paragraph (b)(4)(ii)).

(B) *Personalty property disposed of one year before realty.* A transferor of personal property associated with the use of real property need not treat such property as a real property interest upon disposition if on the date of disposition the transferor does not expect or intend to dispose of the real property until more than one year later.

However, if the real property is in fact disposed of within the following year, the transferor must treat the personal property as having been a real property interest as of the date on which the personalty was disposed of. If the transferor had not previously filed an income tax return, a return must be filed and tax paid, together with any interest due thereon, by the later of the date on which a tax return or payment is actually due (with extensions), or the 60th day following the date of disposition. If the transferor had previously filed an income tax return, an amended return must be filed and tax paid, together with any interest due thereon, by the later of the dates specified above. Such a transferor may be liable to penalties for failure to file, for late payment of tax, or for understatement of liability, but only if the transferor knew or had reason to anticipate that the real property would be disposed of within one year of the disposition of the associated personal property.

(C) *Personalty disposed of one year after realty.* A disposition of real property shall be disregarded for purposes of subdivision (A)(*2*) of this paragraph (b) (4)(ii) if any right to use or occupy the real property is reacquired within the one-year period referred to in that subdivision. However, the disposition shall not be disregarded if such reacquisition is made in foreclosure of a mortgage or other security interest, in the exercise of a contractual remedy, or in the enforcement of a judgment. If, however, the reacquisition of the porperty is made pursuant to a plan the principal purpose of which is the avoidance of the provisions of section 897, 1445, or 6039C and the regulations thereunder, then the initial disposition shall be disregarded for purposes of subdivision (A)(*2*) of this paragraph (b)(4)(ii).

(D) *Separate dispositions of personalty and realty.* A transferor of personal property associated with the use of real

property need not treat such property as a real property interest upon disposition if within 90 days before or after such disposition the transferor separately disposes of the real property interest to persons that are related neither to the transferor nor to the purchaser of the personal property. A transferor may rely upon this rule unless the transferor knows or has reason to know that the purchasers of the real property and the personal property—

(*1*) Are related persons; or

(*2*) Intend to reassociate the personal property with the use of the real property within one year of the date of disposition of the personal property.

(E) *Status of property in hands of transferee*. Personal property that has been associated with the use of real property and that is sold to an unrelated party will be treated as real property in the hands of the transferee only if the personal property becomes associated with the use of real property held or acquired by the transferee, in the manner described in paragraph (b)(4)(i) of this section.

(iii) *Determination dates*. The determination of whether personal property is personal property associated with the use of real property as defined in this paragraph (b)(4) is to be made on the date the personal property is disposed of and on each applicable determination date. See § 1.897–2(c).

(c) *United States real property interest*—(1) *In general*. The term ''United States real property interest'' means any interest, other than an interest solely as a creditor, in either:

(i) Real property located in the United States or the Virgin Islands, or

(ii) A domestic corporation unless it is established that the corporation was not a U.S. real property holding corporation within the period described in section 897(c)(1)(A)(ii).

In addition, for the limited purpose of determining whether any corporation is a U.S. real property holding corporation, the term ''United States real property interest'' means an interest, other than an interest solely as a creditor, in a foreign corporation unless it is established that the foreign corporation is not a U.S. real property holding corporation within the period prescribed in section 897(c)(1)(A)(ii). See § 1.897–2 for rules regarding the manner of establishing that a corporation is not a United States real property holding corporation.

(2) *Exceptions and special rules*—(i) *Domestically-controlled REIT*. An interest in a domestically-controlled real estate investment trust (REIT) is not a U.S. real property interest. A domestically-controlled REIT is one in which less than 50 percent of the fair market value of the outstanding stock was directly or indirectly held by foreign persons during the five-year period ending on the applicable determination date (or the period since June 18, 1980, if shorter). For purposes of this determination the actual owners of stock, as determined under § 1.857–8, must be taken into account.

(ii) *Corporation that has disposed of all U.S. real property interests*. The term ''United States real property interest'' does not include an interest in a corporation which has disposed of all its U.S. real property interests in transactions in which the full amount of gain, if any, was recognized, as provided by section 897(c)(1)(B). See § 1.897–2(f) for rules regarding the requirements of section 897(c)(1)(B).

(iii) *Publicly-traded corporations*. If, at any time during the calendar year, any class of stock of a domestic corporation is regularly traded on an established securities market, an interest in such corporation shall be treated as a U.S. real property interest only in the case of:

(A) A regularly traded interest owned by a person who beneficially owned more than 5 percent of the total fair market value of that class of interests at any time during the five-year period ending either on the date of disposition of such interest or other applicable determination date (or the period since June 18, 1980, in shorter), or

(B) [Reserved]

Separate non-regularly traded interests that were acquired in transactions more than three years apart shall not be cumulated pursuant to this rule. In determining whether a shareholder holds 5 percent of a class of stock in a corporation (or any other interest of an equivalent fair market value), section 318(a) shall apply (except that sections 318(a) (2)(C) and (3)(C) are applied by

substituting the phrase ''5 percent'' for ''50 percent'').

(iv) *Publicly traded partnerships and trusts.* If any class of interests in a partnership or trust is, within the meaning of §1.897–1(m) and (n), regularly traded on an established securities market, then for purposes of sections 897(g) and 1445 and §1.897–2 (d) and (e) an interest in the entity shall not be treated as an interest in a partnership or trust. Instead, such an interest shall be subject to the rules applicable to interests in publicly traded corporations pursuant to paragraph (c)(2)(iii) of this section. Such interests can be real property interests in the hands of a person that holds a greater than 5 percent interest. Therefore, solely for purposes of determining whether greater than 5 percent interests in such an entity constitute U.S. real property interests the disposition of which is subject to tax, the entity is required to determine pursuant to the provisions of §1.897–2 whether the assets it holds would cause it to be classified as a U.S. real property holding corporation if it were a corporation. The treatment of dispositions of U.S. real property interests by publicly traded partnerships and trusts is not affected by the rules of this paragraph (c)(2)(iv); by reason of the operation of section 897(a), foreign partners or beneficiaries are subject to tax upon their distributive share of any gain recognized upon such dispositions by the partnership or trust. The rules of this paragraph (c)(2)(iv) are illustrated by the following example.

Example. PTP is a partnership one class of interests in which is regularly traded on an established securities market. A is a nonresident alien individual who owns 1 percent of a class of limited partnership interests in PTP. B is a nonresident alien individual who owns 10 percent of the same class of limited partnership interests in PTP. On July 1, 1986, A and B sell their interests in PTP. Pursuant to the rules of this paragraph (c)(2)(iv), neither disposition is treated as the disposition of a partnership interest subject to the provisions of section 897(g). Instead, A and B are treated as having disposed of interests in a publicly traded corporation. Therefore, pursuant to the rule of paragraph (c)(2)(iii) of this section, A's disposition of a 1 percent interest has no consequences under section 897. However, B's disposition of a 10 percent interest will constitute the disposition of a U.S. real property interest subject to tax by reason of the operation of section 897 unless it is established pursuant to the rules of §1.897–2 that the interest is not a U.S. real property interest.

(d) *Interest other than an interest solely as a creditor*—(1) *In general.* This paragraph defines an interest other than an interest solely as a creditor, with respect to real property, and with respect to corporations, partnerships, trusts, and estates. An interest solely as a creditor either in real property or in a domestic corporation does not constitute a United States real property interest. Similarly, where one corporation holds an interest solely as a creditor in a second corporation or in a partnership, trust, or estate, that interest will be disregarded for purposes of determining whether the first corporation is a U.S. real property holding corporation (except to the extent that such interest constitutes an asset used or held for use in a trade or business, in accordance with rules of §1.897–1(f)). In addition, the disposition of an interest solely as a creditor in a parnership, trust, or estate is not subject to sections 897, 1445, and 6039C. Whether an interest is considered debt under any provisions of the Code is not determinative of whether it constitutes an interest solely as a creditor for purpose of sections 897, 1445, and 6039C and the regulations thereunder.

(2) *Interests in real property other than solely as creditor*—(i) *In general.* An interest in real property other than an interest solely as a creditor includes a fee ownership, co-ownership, or leasehold interest in real property, a time sharing interest in real property, and a life estate, remainder, or reversionary interest in such property. The term also includes any direct or indirect right to share in the appreciation in the value, or in the gross or net proceeds or profits generated by, the real property.

A loan to an individual or entity under the terms of which a holder of the indebtedness has any direct or indirect right to share in the appreciation in value of, or the gross or net proceeds or profits generated by, an interest in

real property of the debtor or of a related person is, in its entirety, an interest in real property other than solely as a creditor. An interest in production payments described in section 636 does not generally constitute an interest in real property other than solely as a creditor. However, a right to production payments shall constitute an interest in real property other than solely as a creditor if it conveys a right to share in the appreciation in value of the mineral property. A production payment that is limited to a quantum of mineral (including a percentage of recoverable reserves produced) or a period of time will be considered to convey a right to share in the appreciation in value of the mineral property. The rules of this paragraph (d)(2)(i) are illustrated by the following example.

Example. A, a U.S. citizen, purchases a condominium unit located in the United States for $500,000. A makes a $100,000 down payment and borrows $400,000 from B, a foreign person, to pay the balance of the purchase price. Under the terms of the loan. A is to pay B 13 percent annual interest each year for 10 years and 35 percent of the appreciation in the fair market value of the condominum at the end of the 10-year period. Because B has a right to share in the appreciation in value of the condominium, B has an interest other than solely as a creditor in the condominium. B's entire interest in the obligation from A, therefore, is a United States real property interest.

(ii) *Special rule*—(A) *Installment obligations.* A right to installment or other deferred payments from the disposition of an interest in real property will constitute an interest solely as a creditor if the transferor elects not to have the installment method of section 453(a) apply, any gain or loss is recognized in the year of disposition, and all tax due is timely paid. See section 1445 and regulations thereunder for further guidance concerning the availability of installment sale treatment under section 453. If an agreement for the payment of tax with respect to an installment sale is entered into with the Internal Revenue Service pursuant to section 1445, that agreement may specify whether or not the installment obligation will constitute an interest solely as a creditor. If an installment obligation constitutes an interest other than solely as a creditor then the receipt of each payment shall be treated as the disposition of an interest in real property that is subject to section 897(a) to the extent of any gain required to be taken into account pursuant to section 453.

If the original holder of an installment obligation that constitutes an interest other than solely as a creditor subsequently disposes of the obligation to an unrelated party and recognizes gain or loss pursuant to section 453B, the obligation will constitute an interest in real property solely as a creditor in the hands of the subsequent holder. However, if the obligation is disposed of to a related person and the full amount of gain realized upon the disposition of the real property has not been recognized upon such disposition of the installment obligation, then the obligation shall continue to be an interest in real property other than solely as a creditor in the hands of the subsequent holder subject to the rules of this paragraph (d)(2)(ii)(A).

In addition, if the obligation is disposed of to any person for a principal purpose of avoiding the provisions of sections 897, 1445, or 6039C, then the obligation shall continue to be an interest in real property other than solely as a creditor in the hands of the subsequent holder subject to the rules of this paragraph (d)(2)(ii)(A). However, rights to payments arising from dispositions that took place before June 19, 1980, shall in no event constitute interests in real property other than solely as a creditor, even if such payments are received after June 18, 1980. In addition, rights to payments arising from dispositions to unrelated parties that took place before January 1, 1985, and that were not subject to U.S. tax pursuant to the provisions of a U.S. income tax treaty, shall not constitute interests in real property other than solely as a creditor, even if such payments are received after December 31, 1984.

(B) *Options.* An option, a contract or a right of first refusal to acquire any interest in real property (other than an interest solely as a creditor) will itself constitute an interest in real property other than solely as a creditor.

(C) *Security interests.* A right to repossess or foreclose on real property under

a mortgage, security agreement, financing statement, or other collateral instrument securing a debt will not be considered a reversionary interest in, or a right to share in the appreciation in value of or gross or net proceeds or profits generated by, an interest in real property. Thus, no such right of repossession or foreclosure will of itself cause an interest in real property which is otherwise an interest solely as a creditor to become an interest other than solely as a creditor. In addition, a person acting as mortgagee in possession shall not be considered to hold an interest in real property other than solely as a creditor, if the mortgagee's interest in the property otherwise constitutes an interest solely as a creditor.

(D) *Indexed interest rates.* An interest will not constitute a right to share in the appreciation in the value of, or gross or net proceeds or profits generated by, real property solely because it bears a rate of interest that is tied to an index of any kind that is intended to reflect general inflation or deflation of prices and interest rates (e.g., the Consumer Price Index). However, where an interest in real property bears a rate of interest that is tied to an index the principal purpose of which is to reflect changes in real property values, the real property interest will be considered an indirect right to share in the appreciation in value of, or gross or net proceeds or profits generated by, real property. Such an indirect right constitutes an interest in real property other than solely as a creditor.

(E) *Commissions.* A right to payment of a commission, brokerage fee, or similar charge for professional services rendered in connection with the arrangement or financing of a purchase, sale, or lease of real property does not constitute a right to share in the appreciation in value of, or gross or net proceeds or profits of, real property solely because it is based upon a percentage of the purchase price or rent. Thus, a right to a commission earned by a real estate agent based on a percentage of the sales price does not constitute an interest in real property other than solely as a creditor.

However, a right to a commission, brokerage fee, or similar charge will constitute an interest other than solely as a creditor if the total amount of the payment is contingent upon appreciation, proceeds, or profits of the real property occurring or arising after the date of the transaction with respect to which the professional services were rendered. For example, a commission earned in connection with the purchase of a real property interest that is contingent upon the amount of gain ultimately realized by the purchaser will constitute an interest in real property other than solely as a creditor.

(F) *Trustees' fees, etc.* A right to payment of reasonable compensation for services rendered as a trustee, as an administrator of an estate, or in a similar capacity does not constitute a right to share in the appreciation in the value of, or gross or net proceeds or profits of, real property solely because the assets of the trust or estate include U.S. real property interests.

(3) *Interest in an entity other than solely as a creditor*—(i) In general. For purposes of sections 897, 1445, and 6039C, an interest in an entity other than an interest solely as a creditor is—

(A) Stock of a corporation;

(B) An interest in a partnership as a partner within the meaning of section 761(b) and the regulations thereunder;

(C) An interest in a trust or estate as a beneficiary within the meaning of section 643(c) and the regulations thereunder or an ownership interest in any portion of a trust as provided in sections 671 through 679 and the regulations thereunder;

(D) An interest which is, in whole or in part, a direct or indirect right to share in the appreciation in value of an interest in an entity described in subdivision (A), (B), or (C) of this paragraph (d)(3)(i) or a direct or indirect right to share in the appreciation in value of assets of, or gross or net proceeds or profits derived by, the entity; or

(E) A right (whether or not presently exercisable) directly or indirectly to acquire, by purchase, conversion, exchange, or in any other manner, an interest described in subdivision (A), (B), (C), or (D) of this paragraph (d)(3) (i).

(ii) *Special rules*—(A) *Installment obligations.* A right to installment or other deferred payments from the disposition

of an interest in an entity will constitute an interest solely as a creditor if the transferor elects not to have the installment method of section 453(a) apply, any gain or loss is recognized in the year of disposition, and tax due is timely paid. See section 1445 and regulations thereunder for further guidance concerning the availability of installment sale treatment under section 453. If an agreement for the payment of tax with respect to an installment sale is entered into with the Internal Revenue Service pursuant to section 1445, that agreement may specify whether or not the installment obligation will constitute an interest solely as a creditor. If an installment obligation constitutes an interest other than solely as a creditor then the receipt of each payment shall be treated as the disposition of such an interest and shall be subject to section 897(a) to the extent that:

(*1*) It constitutes the disposition of a U.S. real property interest and

(*2*) Gain or loss is required to be taken into account pursuant to section 453. Such treatment shall apply to payments arising from dispositions of interests in a corporation any class of the stock of which is regularly traded on an established securities market, but only in the case of a disposition of any portion of an interest described in paragraph (c)(2)(iii)(A) or (B) of this section. If the original holder of an installment obligation that constitutes an interest other than solely as a creditor subsequently disposes of the obligation to an unrelated party and recognizes gain or loss pursuant to section 453B, the obligation will constitute an interest in the entity solely as a creditor in the hands of the subsequent holder. However, if the obligation is disposed of to a related person and the full amount of gain realized upon the disposition of the interest in the entity has not been recognized upon such disposition of the installment obligation, then the obligation shall continue to be an interest in the entity other than solely as a creditor in the hands of the subsequent holder subject to the rules of this paragraph (d)(3)(ii)(A). In addition, if the obligation is disposed of to any person for a principal purpose of avoiding the provisions of section 897, 1445, or 6039C, then the obligation shall continue to be an interest in the entity other than solely as a creditor in the hands of the subsequent holder subject to the rules of this paragraph (d)(3)(ii)(A). However, rights to payments arising from dispositions that took place before June 19, 1980, shall in no event constitute interests in an entity other than solely as a creditor, even if such payments are received after June 18, 1980. In addition, such treatment shall not apply to payments arising from dispositions to unrelated parties that took place before January 1, 1985, and that were not subject to U.S. tax pursuant to the provisions of a U.S. income tax treaty, regardless of when such payments are received.

(B) *Contingent interests.* The interests described in subdivision (D) of paragraph (d)(3)(i) of this section include any right to a payment from an entity the amount of which is contingent on the appreciation in value of an interest described in subdivision (A), (B), or (C) of paragraph (d)(3)(i) of this section or which is contingent on the appreciation in value of assets of, or the general gross or net proceeds or profits derived by, such entity. The right to such a payment is itself an interest in the entity other than solely as a creditor, regardless of whether the holder of such right actually holds an interest in the entity described in subdivision (A), (B), or (C) of paragraph (d)(3)(i) of this section. For example, a stock appreciation right constitutes an interest in a corporation other than solely as a creditor even if the holder of such right actually holds no stock in the corporation. However, the interests described in subdivision (D) of paragraph (d)(3)(i) of this section do not include any right to a payment that is (*1*) exclusively contingent upon and exclusively paid out of revenues from sales of personal property (whether tangible or intangible) or from services, or (*2*) exclusively contingent upon the resolution of a claim asserted against the entity by a person related neither to the entity nor to the holder of the interest.

(C) *Security interests.* A right to repossess or foreclose on an interest in an entity under a mortgage, security agreement, financing statement, or other collateral instrument securing a

debt will not of itself cause an interest in an entity which is otherwise an interest solely as a creditor to become an interest other than solely as a creditor.

(D) *Royalties.* The interests described in subdivision (D) of paragraph (d)(3)(i) of this section do not include rights to payments representing royalties, license fees, or similar charges for the use of patents, inventions, formulas, copyrights, literary, musical or artistic compositions, trademarks, trade names, franchises, licenses, or similar intangible property.

(E) *Commissions.* The interests described in subdivision (D) of paragraph (d)(3)(i) of this section do not include a right to a commission, brokerage fee or similar charge for professional services rendered in connection with the purchase or sale of an interest in an entity. However, a right to such a payment will constitute an interest other than solely as a creditor if the total amount of the payment is contingent upon appreciation in value of assets of, or proceeds or profits derived by, the entity after the date of the transaction with respect to which the payment was earned.

(F) *Trustee's fees.* The interests described in subdivision (D) of paragraph (d)(3)(i) of this section do not include a right to payment representing reasonable compensation for services rendered as a trustee, as an administrator of an estate, or in a similar capacity.

(4) *Aggregation of interests.* If a person holds both interests solely as a creditor and interests other than solely as a creditor in real property or in an entity, those interests will generally be treated as separate and distinct interests. However, such interests shall be aggregated and treated as interests other than solely as a creditor in their entirety if the interest solely as a creditor has been separated from, or acquired separately from, the interest other than solely as a creditor, for a principal purpose of avoiding the provisions of section 897, 1445, or 6039C by causing one or more of such interests to be an interest solely as a creditor. The existence of such a purpose will be determined with reference to all the facts and circumstances. Where an interest solely as a creditor has arm's-length interest and repayment terms it shall in no event be aggregated with and treated as an interest other than solely as a creditor. For purposes of this paragraph (d)(4), an interest rate that does not exceed 120 percent of the applicable Federal rate (as defined in section 1274(d)) shall be presumed to be an arm's-length interest rate. For purposes of applying the rules of this paragraph (d)(4), a person shall be treated as holding any interests held by a related person within the meaning of § 1.897–1(i).

(5) *''Interest'' means ''interest other than solely as a creditor.''* Unless otherwise stated, the term ''interest'' as used with regard to real property or with regard to an entity hereafter in the regulations under sections 897, 1445, and 6039C, means an interest in such real property or entity other than an interest solely as a creditor.

(e) *Proportionate share of assets held by an entity*—(1) *In general.* A person that holds an interest in an entity is for certain purposes treated as holding a proportionate or pro rata share of the assets held by the entity. Such proportionate share must be calculated, in accordance with the rules of this paragraph, for the following purposes.

(i) In determining whether a corporation is a U.S. real property holding corporation—

(A) A person holding an interest in a partnership, trust, or estate is treated as holding a proportionate share of the assets held by the partnership, trust, or estate (see section 897–2(e)(2)), and

(B) A corporation that holds a controlling interest in a second corporation is treated as holding a proportionate share of the assets held by the second corporation (see § 1.897–2(e)(3)).

(ii) In determining reporting obligations that may be imposed under section 6039C, the holder of an interest in a partnership, trust, or estate is treated as owning a proportionate share of the U.S. real property interests held by the partnership, trust, or estate.

(2) *Proportionate share of assets held by a corporation or partnership*—(i) *In general.* A person's proportionate or pro rata share of assets held by a corporation or partnership is determined by multiplying—

(A) The person's percentage ownership interest in the entity, by

(B) The fair market value of the assets held by the entity (or the book value of such assets, in the case of a determination pursuant to §1.897–2(b)(2)).

(ii) *Percentage ownership interest.* A person's percentage ownership interest in a corporation or partnership is the percentage equal to the ratio of (A) the sum of the liquidation values of all interests in the entity held by the person to (B) the sum of the liquidation values of all outstanding interest in the entity. The liquidation value of an interest in an entity is the amount of cash and the fair market value of any property that would be distributed with respect to such interest upon the liquidation of the entity after satisfaction of liabilities to persons having interests in the entity solely as creditors. With respect to an entity that has interests outstanding that grant a presently-exercisable option to acquire or right to convert into or otherwise acquire an interest in the entity other than solely as a creditor, the liquidation value of all interests in such entity shall be calculated as though such option or right had been exercised, giving effect both to the payment of any consideration required to exercise the option or right and to the issuance of the additional interest.

The fair market value of the assets of the entity, the amount of cash held by the entity, and the amount of liabilities to persons having interests solely as creditors if determined for this purpose on the date with respect to which the percentage ownership interest is determined.

(iii) *Examples.* The rules of this paragraph (e)(2) are illustrated by the following examples.

Example 1. Corporation K's only assets are stock and securities with a fair market value as of the applicable determination date of $20,000,000 K's assets are subject to liabilities of $10,000,000. Among K's liabilities are a $1,000,000 loan from L, under the terms of which L is entitled, upon payment of the loan principal, to a profit share equal to 10 percent of the excess of the fair market value of K's assets over $18,000,000, but only if all other corporate liabilities have been paid. K has two classes of stock, common and preferred. PS1 and PS2 each own 100 of the 200 outstanding shares of preferred stock. CS1 and CS2 each own 500 of the 1,000 outstanding shares of common stock. Each preferred shareholder is entitled to $10,000 per share of preferred stock upon liquidation, subject to payment of all corporate liabilities and to any amount owed to L, but before any common shareholder is paid. The liquidation value of L's interest in K, which constitutes an interest other than an interest solely as a creditor, is $1,200 ($1,000,000 principal of the loan to K plus $200,000 (10 percent of the excess of $20,000,000 over $18,000,000). The liquidation value of each of PS1's and PS2's blocks of preferred stock is $1,000,000 ($10,000 times 100 shares each). The liquidation value of each of CS1's and CS2's blocks of common stock is $3,900,000 [$20,000,000 (the total fair market value of K's assets)—$9,000,000 (liabilities to creditors other than L)—$1,200,000 (L's liquidation value)—$2,000,000 (PS1's and PS2's liquidation value)) times 50 percent (the percentage of common stock owned by each)]. The sum of the liquidation values of all of the outstanding interests in K (i.e., interests other than solely as a creditor) is $11,000,000 [$1,200,000 (L's liquidation value) + $2,000,000 (PS1's and PS2's liquidation values) + $7,800,000 (CS1's and CS2's liquidation values)]. Each of CS1's and CS2's percentage ownership interests in K is 35.5 percent ($3,900,000 divided by $11,000,000). Each of PS1's and PS2's percentage ownership interests in K is 9 percent ($1,000,000 divided by $11,000,000). L's percentage ownership interest in K is 11 percent ($1,200,000 divided by $11,000,000).

Example 2. A, a U.S. person, and B, a foreign person are partners in a partnership the only asset of which is a parcel of undeveloped land located in the United States that was purchased by the partnership in 1980 for $300,000. The partnership has no liabilities, and its capital is $300,000. A's and B's interests in the capital of the partnership are 25 percent and 75 percent, respectively, and A and B each has a 50 percent profit interest in the partnership. The partnership agreement provides that upon liquidation any unrealized gain will be distributed in accordance with the partners' profit interest. In 1984 the partnership has no items of income or deduction, and the fair market value of its parcel of undeveloped land is $500,000. In 1984 the percentage ownership interest of A in the partnership is 35 percent [the ratio of $100,000 (the liquidation value of A's profit interest in 1984) plus $75,000 (the liquidation value of A's 25 percent interest in the partnership's $300,000 capital) to $500,000 (the sum of the liquidation values of all outstanding interests in the partnership)]. The percentage ownership interest of B in the partnership in 1984 is 65 percent [the ratio of $325,000 (B's $100,000 profit interest plus his $225,000 capital interest) to $500,000]

(3) *Proportionate share of assets held by trusts and estates*—(i) *In general.* A person's proportionate or pro rata share of assets held by a trust or estate is determined by multiplying—

(A) The person's percentage ownership interest in the trust or estate, by

(B) The fair market value of the assets held by the trust or estate (or the book value of such assets, in the case of a determination pursuant to §1.897–2(b)(2)).

(ii) *Percentage ownership interest*—(A) *General rule.* A person's percentage ownership interest in a trust or an estate—is the percentage equal to the ratio of:

(*1*) The sum of the actuarial values of such person's interests in the cash and other assets held by the trust or estate after satisfaction of the liabilities of the trust or estate to persons holding interests in the trust or estate solely as creditors, to (*2*) the entire amount of such cash and other assets after satisfaction of liabilities to persons holding interests in the trust or estate solely as creditors. For purposes of calculating this ratio, the fair market value of the trust's or estate's assets, the amount of cash held by the trust or estate, and the amount of the liabilities to persons having interests solely as creditors is determined on the date with respect to which the percentage ownership interest is determined. With respect to a trust or estate that has interests outstanding that grant a presently-exercisable option to acquire or right to convert into or otherwise acquire an interest in the trust or estate other than solely as a creditor, the liquidation value of all interests in such entity shall be calculated as though such option or right had been exercised, giving effect both to the payment of any consideration required to exercise the option or right and to the issuance of the additional interest. With respect to a trust or estate that has interests outstanding that entitle any person to a distribution of U.S. real property interests upon liquidation that is disproportionate to such person's interest in the total assets of the trust or estate, such disproportionate right shall be disregarded in the calculation of the interest-holders' proportionate share of the U.S. real property interests held by the entity. For purposes of determining his own percentage ownership interest in a trust, a grantor or other person will be treated as owning any portion of the trust's cash and other assets which such person is treated as owning under sections 671 through 679.

(B) *Discretionary trusts and estates.* In determining percentage ownership interest in a trust or an estate, the sum of the definitely ascertainable actuarial values of interests in the cash and the other assets of the trust or estate held by persons in existence on the date with respect to which such determination is made must equal the amount in paragraph (e)(3)(ii)(A)(*2*) of this section. If the amount in paragraph (e)(3)(ii)(A)(*2*) of this section exceeds the sum of the definitely ascertainable actuarial values of the interests held by persons in existence on the determination date, the excess will be considered to be owned in total by each beneficiary who is in existence on such date, whose interest in the excess is not definitely ascertainable and who is potentially entitled to such excess. However, such excess shall not be considered to be owned in total by each beneficiary if the discretionary terms of the trust or estate were included for a principal purpose of avoiding the provisions of section 897, 1445, or 6039C by causing assets other than U.S. real property interests to be attributed in total to each beneficiary. The rules of this paragraph (e)(3) are illustrated by the following example.

Example. A, a U.S. person, established a trust on December 31, 1984, and contributed real property with a fair market value of $10,000 to the trust. The terms of that trust provided that the trustee, a bank that is unrelated to A, at its discretion may retain trust income or may distribute it to X, a foreign person, or to the head of state of any country other than the United States. The remainder upon the death of X is to go in equal shares to such of Y and Z, both foreign persons, as survive X. On December 31, 1984, the total value of the trust's assets is $10,000. On the same date, the actuarial values of the remainder interests of Y and Z in the corpus of the trust are definitely ascertainable. They are $1,000 and $500, respectively. Neither the income interest of X nor of the head of state of any country other than the United States has a definitely ascertainable

actuarial value on December 31, 1984. The interests of Y and Z in the income portion of the trust similarly have no definitely ascertainable actuarial values on such date since the income may be distributed rather than retained by the trust. Since the sum of the actuarial values of definitely ascertainable interests of persons in existence ($1,500) is less than $10,000, the difference ($8,500) is treated as owned by each beneficiary who is in existence on December 31, 1984, and who is potentially entitled to such excess. Therefore, X, Y, Z, and the head of state of any country other than the United States are each considered as owning the entire $8,500 income interest in the trust. On December 31, 1984, the total actuarial value of X's interest is $8,500, and his percentage ownership interest is 85 percent. The total actuarial value of Y's interest in the trust is $9,500 ($1,000 plus $8,500), and his percentage ownership interest is 95 percent. The total actuarial value of Z's interest is $9,000 ($500 plus $8,500), and his percentage ownership interest is 90 percent. The actuarial value of the interest of the head of state of each country other than the United States is $8,500, and his percentage ownership interest is 85 percent.

(4) *Dates with respect to which percentage ownership interests are determined.* The dates with respect to which percentage ownership interests are determined are the applicable determination dates outlined in § 1.897–2 or in regulations under section 6039C.

(f) *Asset used or held for use in a trade or business*—(1) *In general.* The term ''asset used or held for use in a trade or business'' means—

(i) Property, other than a U.S. real property interest, that is—

(A) Stock in trade of an entity or other property of a kind which would properly be included in the inventory of the entity if on hand at the close of the taxable year, or property held by the entity primarily for sale to customers in the ordinary course of its trade or business, or

(B) Depreciable property used or held for use in the trade or business, as described in section 1231(b)(1) but without regard to the holding period limitations of section 1231(b), or

(C) Livestock, including poultry, used or held for use in a trade or business for draft, breeding, dairy, or sporting purposes, and

(ii) Goodwill and going concern value, patents, inventions, formulas copyrights, literary, musical, or artistic compositions, trademarks, trade names, franchises, licenses, customer lists, and similar intangible property, but only to the extent that such property is used or held for use in the entity's trade or business and subject to the valuation rules of § 1.897–1(o)(4), and

(iii) Cash, stock, securities, receivables of all kinds, options or contracts to acquire any of the foregoing, and options or contracts to acquire commodities, but only to the extent that such assets are used or held for use in the corporation's trade or business and do not constitute U.S. real property interests.

(2) *Used or held for use in a trade or business.* An asset is used or held for use in an entity's trade or business if it is, under the principles of § 1.864–4(c)(2)—

(i) Held for the principal purpose of promoting the present conduct of the trade or business,

(ii) Acquired and held in the ordinary course of the trade or business, as, for example, in the case of an account or note receivable arising from that trade or business (including the performance of services), or

(iii) Otherwise held in a direct relationship to the trade or business.

In determining whether an asset is held in a direct relationship to the trade or business, consideration shall be given to whether the asset is needed in that trade or business. An asset shall be considered to be needed in a trade or business only if the asset is held to meet the present needs of that trade or business and not its anticipated future needs. An asset shall be considered as needed in the trade or business if, for example, the asset is held to meet the operating expenses of that trade or business. Conversely, an asset shall be considered as not needed in the trade or business if, for example, the asset is held for the purpose of providing for future diversification into a new trade or business, future expansion of trade or business activities, future plant replacement, or future business contingencies. An asset that is held to meet reserve or capitalization requirements imposed by applicable law shall be presumed to be held in a direct relationship to the trade or business.

(3) *Special rules concerning liquid assets*—(i) *Safe harbor amount*. Assets described in paragraph (f)(1)(iii) of this section shall be presumed to be used or held for use in a trade or business, in an amount up to 5 percent of the fair market value of other assets used or held for use in the trade or business. However, the rule of this paragraph (f)(3)(i) shall not apply with respect to any assets described in paragraph (f)(1)(iii) of this section that are held or acquired for the principal purpose of avoiding the provisions of section 897 or 1445.

(ii) *Investment companies*. Assets described in paragraph (f)(1)(iii) of this section shall be presumed to be used or held for use in an entity's trade or business if the principal business of the entity is trading or investing in such assets for its own account. An entity's principal business shall be presumed to be trading or investing in assets described in paragraph (f)(1)(iii) of this section if the fair market value of such assets held by the entity equals or exceeds 90 percent of the sum of the fair market values of the entity's U.S. real property interests, interests in real property located outside the United States, assets otherwise used or held for use in trade or business, and assets described in paragraph (f)(1)(iii) of this section.

(4) *Examples*. The application of this paragraph (f) may be illustrated by the following examples:

Example 1. M, a domestic corporation engaged in industrial manufacturing, is required to hold a large current cash balance for the purposes of purchasing materials and meeting its payroll. The amount of the cash balance so required varies because of the fluctuating seasonal nature of the corporation's business. In months when large cash balances are not required, the corpration invests the surplus amount in U.S. Treasury bills. Since both the cash and the Treasury bills are held to meet the present needs of the business, they are held in a direct relationship to that business, and, therefore, constitute assets used or held for use in the trade or business.

Example 2. R, a domestic corporation engaged in the manufacture of goods, engages a stock brockerage firm to manage securities which were purchased with funds from R's general surplus reserves. The funds invested in these securities are intended to provide for the future expansion of R into a new trade or business. Thus, the funds are not necessary for the present needs of the business; they are accordingly not held in a direct relationshp to the business and do not constitute assets used or held for use in the trade or business.

Example 3. B, a federally chartered and regulated bank, is required by law to hold substantial reserves of cash, stock, and securities. Pursuant to the rule of paragraph (f)(2) of this section, such assets are presumed to be held in a direct relationship to B's business, and thus constitute assets used or held for use in the trade or business. In addition, B holds substantial loan receivables which are acquired and held in the ordinary course of its banking business. Pursuant to the rule of paragraph (f)(1)(iii) of this section, such receivables constitute assets used or held for use in the trade or business.

(g) *Disposition*. For purposes of sections 897, 1445, and 6039C, the term ''disposition'' means any transfer that would constitute a disposition by the transferor for any purpose of the Internal Revenue Code and regulations thereunder. The severance of crops or timber and the extracion of minerals do not alone constitute the disposition of a U.S. real property interest.

(h) *Gain or loss*. The amount of gain or loss arising from the disposition of the U.S. real property interest shall be determined as provided in section 1001 (a) and (b). Such gain or loss shall be subject to the provisions of section 897 (a) and (b), unless a nonrecognition provision is applicable pursuant to section 897 (d) or (e) and regulations thereunder. Amounts otherwise treated for Federal income tax purposes as principal and interest payments on debt obligations of all kinds (including obligations that are interests other than solely as a creditor) do not give rise to gain or loss that is subject to section 897(a). However, principal payments on installment obligations described in §§ 1.897–1(d)(2)(ii)(A) and 1.897–1(d)(3)(ii)(A) do give rise to gain or loss that is subject to section 897(a), to the extent such gain or loss is required to be recognized pursuant to section 453. The rules of paragraphs (g) and (h) are illustrated by the following examples.

Example 1. Foreign individual C has an undivided fee interest in a parcel of real property located in the United States. The fair market value of C's interest is $70,000, and C's basis in such interest is $50,000. The only liability to which the real property is subject

is the liability of $65,000 secured by a mortgage in the same amount. C transfers his fee interest in the property subject to the mortgage by gift to D. C realizes $15,000 of gain upon such transfer. As a transfer by gift constitutes a disposition for purposes of the Code, and as gain is realized upon that transfer, the gift is a disposition for purposes of sections 897, 1445, and 6039C and is subject to section 897(a) to the extent of the gain realized. However, section 897(a) would not be applicable to the transfer if the mortgage on the U.S. real property were equal to or less than C's $50,000 basis, since the transfer then would not give rise to the realization of gain or loss under the Internal Revenue Code.

Example 2. Foreign corporation Y makes a loan of $1 million to domestic individual Z, secured by a mortgage on residential real property purchased with the loan proceeds. The loan agreement provides that Y is entitled to receive fixed monthly payments from Z, constituting repayment of principal plus interest at a fixed rate. In addition, the agreement provides that Y is entitled to receive a percentage of the appreciation value of the real property as of the time that the loan is retired. The obligation in its entirety is considered debt for Federal income tax purposes. However, because of Y's right to share in the appreciation in value of the real property, the debt obligation gives Y an interest in the real property other than solely as a creditor. Nevertheless, as principal and interest payments do not constitute gain under section 1001 and paragraph (h) of this section, and both the monthly and final payments received by Y are considered to consist solely of principal and interest for Federal income tax purposes, section 897(a) shall not apply to Y's receipt of such payments. However, Y's sale of the debt obligation to foreign corporation A would give rise to gain that is subject to section 897(a).

(i) *Related person.* For purposes of sections 897, 1445, and 6039C, persons are considered to be related if they are partners or partnerships described in section 707(b)(1) of the Code or if they are related within the meaning of section 267 (b) and (c) of the Code (except that section 267(f) shall apply without regard to section 1563(b)(2)).

(j) *Domestic corporation.* The term ''domestic corporation'' has the same meaning as set forth in section 7701(a)(3) and (4) and § 301.7701–5. For purposes of sections 897 and 6039C, it also includes a foreign corporation with respect to which an election under section 897(i) and § 1.897–3 or section 897(k) and § 1.897–4 to be treated as domestic corporation is in effect.

(k) [Reserved]

(l) *Foreign corporation.* The term ''foreign corporation'' has the meaning ascribed to such term in section 7701(a)(3) and (5) and § 301.7701–5. For purposes of sections 897 and 6039C, however, the term does not include a foreign corporation with respect to which there is in effect an election under section 897(i) and § 1.897–3 or section 897(k) and § 1.897–4 to be treated as a domestic corporation.

(m) *Established securities market.* For purposes of sections 897, 1445, and 6039C, the term ''established securities market'' means—

(1) A national securities exchange which is registered under section 6 of the Securities Exchange Act of 1934 (15 U.S.C. 78f),

(2) A foreign national securities exchange which is officially recognized, sanctioned, or supervised by governmental authority, and

(3) Any over-the-counter market. An over-the-counter market is any market reflected by the existence of an interdealer quotation system. An interdealer quotation system is any system of general circulation to brokers and dealers which regularly disseminates quotations of stocks and securities by identified brokers or dealers, other than by quotation sheets which are prepared and distributed by a broker or dealer in the regular course of business and which contain only quotations of such broker or dealer.

(n) [Reserved]

(o) *Fair market value*—(1) *In general.* For purposes of sections 897, 1445, and 6039C only, the term ''fair market value'' means the value of the property determined in accordance with the rules, contained in this paragraph (o). The definition of fair market value provided herein is not to be used in the calculation of gain or loss from the disposition of a U.S. real property interest pursuant to section 1001. An independent professional appraisal of the value of property must be submitted only if such an appraisal is specifically requested in connection with the negotiation of a security agreement pursuant to section 1445.

(2) *Method of calculating fair market value*—(i) *In general.* The fair market value of property is its gross value (as defined in paragraph (o)(2)(ii) of this

section) reduced by the outstanding balance of any debts secured by the property which are described in paragraph (o)(2)(iii) of this section. See §1.897–2(b) for the alternative use of book values in certain limited circumstances.

(ii) *Gross value.* Gross value is the price at which the property would change hands between an unrelated willing buyer and willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of all relevant facts. Generally, with respect to trade or business assets, going concern value should be used as it will provide the most accurate reflection of such a price. However, taxpayers may use other methods of valuation if they can establish that such method will provide a more accurate determination of gross value and if they consistently apply such method to all assets to be valued. See subdivisions (3) and (4) of this paragraph (o) for special rules with respect to the valuation of leases and of intangible assets.

(iii) Debts secured by the property. The gross value of property shall be reduced by the outstanding balance of debts that are:

(A) Secured by a mortgage or other security interest in the property that is valid and enforceable under the law of the jurisdiction in which the property is located, and

(B) Either (*1*) Incurred to acquire the property (including long-term financing obtained in replacement of construction loans or other short-term debt within one year of the acquisition or completion of the property), or (*2*) otherwise incurred in direct connection with the property, such as property tax liens upon real property or debts incurred to maintain or improve property.

In addition, if any debt described in this paragraph (o)(2)(iii) is refinanced for a valid business purpose (such as obtaining a more favorable rate of interest), the principal amount of the replacement debt does not exceed the outstanding balance of the original debt, and the replacement debt is secured by the property, then the gross value of the property shall be reduced by the replacement debt. Obligations to related persons shall not be taken into account for purposes of this paragraph (o)(2)(iii) unless such obligations constitute interests solely as a creditor pursuant to the provisions of paragraph (d)(4) of this section and unless the related person has made similar loans to unrelated persons on similar terms and conditions.

(iv) *Anti-abuse rule.* The gross value of real property located outside the United States and of assets used or held for use in a trade or business shall be reduced by the outstanding balance of any debt that was entered into for the principal purpose of avoiding the provisions of section 897, 1445, or 6039C by enabling the corporation to acquire such assets. The existence of such a purpose shall be determined with reference to all the facts and circumstances. Debts that a particular corporation routinely enters into in the ordinary course of its acquisition of assets used or held for use in its trade or business will not be considered to be entered into for the principal purpose of avoiding the provisions of section 897, 1445, or 6039C.

(3) *Fair market value of leases and options.* For purposes of sections 897, 1445, and 6039C, the fair market value of a leasehold interest in real property is the price at which the lease could be assigned or the property sublet, neither party to such transaction being under any compulsion to enter into the transaction and both having reasonable knowledge of all relevant facts. Thus, the value of a leasehold interest will generally consist of the present value, over the period of the lease remaining, of the difference between the rental provided for in the lease and the current rental value of the real property. A leasehold interest bearing restrictions on its assignment or sublease has a fair market value of zero, but only if those restrictions in practical effect preclude (rather than merely condition) the lessee's ability to transfer, at a gain, the benefits of a favorable lease. The normal commercial practice of lessors may be used to determine whether restrictions in a lease have the practical effect of precluding transfer at a gain. The fair market value of an option to purchase any property is, similarly, the price at which the option

could be sold, consisting generally of the difference between the option price and the fair market value of the property, taking proper account of any restrictions upon the transfer of the option.

(4) *Fair market value of intangible assets.* For purposes of determining whether a corporation is a U.S. real property holding corporation, the fair market value of intangible assets described in §1.897–1(f)(1)(ii) may be determined in accordance with the following rules.

(i) *Purchase price.* Intangible assets described in §1.897–1(f)(1)(ii) that were acquired by purchase from a person not related to the purchaser within the meaning of §1.897–1(i) may be valued at their purchase price. However, such purchase price must be adjusted to reflect any amortization required by generally accepted accounting principles applied in the United States. Intangible assets acquired by purchase shall include any amounts allocated to goodwill or going concern valued pursuant to section 338(b)(3) and regulations thereunder. Intangible assets acquired by purchase shall not include assets that were acquired indirectly through an acquisition of stock to which section 338 does not apply. Such assets must be value pursuant to a method described in subdivision (ii) or (iii) of this paragraph (o)(4).

(ii) *Book value.* Intangible assets described in §1.897–1(f)(1)(ii) (other than good will and going concern value) may be valued at the amount at which such assets are carried on the financial accounting records of the holder of such assets, provided that such amount is determined in accordance with generally accepted accounting principles applied in the United States. However, this method may not be used with respect to assets acquired by purchase from a related person within the meaning of §1.897–1(i).

(iii) *Other methods.* Intangible assets described in §1.897–1(f)(1)(ii) may be valued pursuant to any other reasonable method at an amount reflecting the price at which the asset would change hands between an unrelated willing buyer and willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of all relevant facts. However, a corporation that uses a method of valuation other than the purchase price or book value methods may be required to comply with the special notification requirements of §1.897–2(h)(1)(iii)(A).

(p) *Identifying number.* The ''identifying number'' of an individual is the individual's United States social security number or the identification number assigned by the Internal Revenue Service (see §301.6109–1 of this chapter). The ''identifying number'' of any other person is its United States employer identification number.

(Approved by the Office of Management and Budget under control number 1545–0123)

(Sec. 897 (94 Stat. 2683; 26 U.S.C. 897), sec. 6011 (68A Stat. 732; 26 U.S.C. 6011) and sec. 7805 (68A Stat. 917; 26 U.S.C. 7805) of the Internal Revenue Code of 1954)

[T.D. 7999, 49 FR 50693, Dec. 31, 1984; 50 FR 12530, Mar. 29, 1985, as amended by T.D. 8113, 51 FR 46626, Dec. 24, 1986; T.D. 8198, 53 FR 16217, May 5, 1988; T.D. 8657, 61 FR 9343, Mar. 8, 1996; 61 FR 14248, Apr. 1, 1996; T.D. 9082, 68 FR 46082, Aug. 5, 2003]

§1.897–2 United States real property holding corporations.

(a) *Purpose and scope.* This section provides rules regarding the definition and consequences of U.S. real property holding corporation status. U.S. real property holding corporation status is important for determining whether gain from the disposition by a foreign person of an interest in a domestic corporation is taxable. Such status is also important for purposes of the withholding and reporting requirements of sections 1445 and 6039C. For example, a person that buys stock of a U.S. real property holding corporation from a foreign person is required to withhold under section 1445. In addition, for purposes of determining whether another corporation is a U.S. real property holding corporation, an interest in a foreign corporation is a U.S. real property interest unless it is established that the foreign corporation is not a U.S. real property holding corporation. The general definition of a U.S. real property holding corporation is provided in paragraph (b) of this section. Paragraph (c) provides rules regarding the dates on which U.S. real property

holding corporation status must be determined. The assets that must be included in making the determination of a corporation's status are set forth in paragraph (d), while paragraph (e) provides special rules regarding the treatment of interests held by a corporation in partnerships, trusts, estates, and other corporations. Rules regarding the termination of U.S. real property holding corporation status are set forth in paragraph (f). Paragraph (g) explains the manner in which an interest-holder can establish that a corporation is not a U.S. real property holding corporation, and paragraph (h) provides rules regarding certain notification requirements applicable to corporations.

(b) *U.S. real property holding corporation*—(1) *In general.* A corporation is a U.S. real property holding corporation if the fair market value of the U.S. real property interests held by the corporation on any applicable determination date equals or exceeds 50 percent of the sum of the fair market values of its—

(i) U.S. real property interests;

(ii) Interests in real property located outside the United States; and

(iii) Assets other than those described in subdivision (i) or (ii) of this paragraph (b)(1) that are used or held for use in its trade or business.

See paragraphs (d) and (e) of this section for rules regarding the directly and indirectly held assets that must be included in the determination of whether a corporation is a U.S. real property holding corporation. The term ''interest in real property located outside the United States'' means an interest other than solely as a creditor (as defined in §1.897–1(d)) in real property (as defined in §1.897–(b)) that is located outside the United States or the Virgin Islands. If a corporation qualifies as a U.S. real property holding corporation on any applicable determination date after June 18, 1980, any interest in it shall be treated as a U.S. real property interest for a period of five years from that date, unless the provisions of paragraph (f)(2) of this section are applicable.

(2) *Alternative test*—(i) *In general.* The fair market value of a corporation's U.S. real property interests shall be presumed to be less than 50 percent of the fair market value of the aggregate of its assets described in paragraphs (d) and (e) of this section if on an applicable determination date the total book value of the U.S. real property interests held by the corporation is 25 percent or less of the book value of the aggregate of the corporation's assets described in paragraphs (d) and (e) of this section.

(ii) *Definition of book value.* For purposes of this section and §1.897–1(e) the term ''book value'' shall be defined as follows. In the case of assets that are held directly by the corporation, the term means the value at which an item is carried on the financial accounting records of the corporation, if such value is determined in accordance with generally accepted accounting principles applied in the United States. In the case of assets of which a corporation is treated as holding a pro rata share pursuant to paragraphs (e) (2) and (3) of this section and §1.897–1(e), the term ''book value'' means the corporation's share of the value at which the asset is carried on the financial accounting records of the entity that directly holds the asset, if such value is determined in accordance with generally accepted accounting principles applied in the United States. For purposes of this paragraph (b)(2)(ii), an entity need not keep all of its books in accordance with U.S. accounting principles, so long as the value of the relevant assets is determined in accordance therewith.

(iii) *Denial of presumption.* If the Internal Revenue Service determines, on the basis of information as to the fair market values of a corporation's assets, that the presumption allowed by this paragraph (b)(2) may not accurately reflect the status of the corporation, the Service will notify the corporation that it may not rely upon the presumption. The Service will provide a written notice to the corporation that sets forth the general grounds for the Service's conclusion that the presumption may be inaccurate. By the 90th day following the date on which the corporation receives the Service's notification, the corporation must determine whether on its most recent determination date it was a U.S. real property holding corporation pursuant

to the general rule set forth in paragraph (b)(1) of this section and must notify the Service of its determination. If the corporation determines that it was not a U.S. real property holding corporation pursuant to the general rule, then the corporation may upon future determination dates rely upon the presumption allowed by this paragraph (b)(2), unless on the basis of additional information the Service again requests that the determination be made pursuant to the general rule. If the corporation determines that it was a U.S. real property holding corporation on its most recent determination date, then by the 180th day following the date on which the corporation received the Service's notification the corporation (if a domestic corporation) must notify each holder of an interest in it that contrary to any prior representations it was a U.S. real property holding corporation as of its most recent determination date.

(iv) *Applicability of penalties.* A corporation that had previously relied upon the presumption allowed by this paragraph (b)(2) but that is determined to be a U.S. real property holding corporation shall not be subject to penalties for any incorrect notice previously given pursuant to the requirements of paragraph (h) of this section, if:

(A) The corporation in fact carried out the necessary calculations enabling it to rely upon the presumption allowed by this paragraph (b)(2); and

(B) The corporation complies with the provisions of paragraph (b)(2)(iii) of this section. However, a corporation shall remain subject to any applicable penalties if at the time of its reliance on the presumption allowed by this paragraph (b)(2) the corporation knew that the book value of relevant assets was substantially higher or lower than the fair market value of those assets and therefore had reason to believe that under the general test of paragraph (b)(1) of this section the corporation would probably be a U.S. real property holding corporation. Information with respect to the fair market value of its assets is known by a corporation if such information is included on any books and records of the corporation or its agent, is known by its directors or officers, or is known by employees who in the course of their employment have reason to know such information. A corporation relying upon the presumption allowed by this paragraph (b)(2) has no affirmative duty to determine the fair market values of assets if such values are not otherwise known to it in accordance with the preceding sentence. The rules of this paragraph (b)(2)(iv) may be illustrated by the following examples.

Example 1. DC is a domestic corporation engaged in light manufacturing that knows that it has foreign shareholders. On its December 31, 1985 determination date DC held assets used in its trade or business, consisting largely of recently-purchased equipment, with a book value of $500,000. DC's only real property interest was a factory that it had occupied for over 50 years, which had a book value of $200,000. The factory was located in a deteriorated downtown area, and DC had no knowledge of any facts indicating that the fair market value of the property was substantially higher than its book value. Therefore, DC was entitled to rely upon the presumption allowed by §1.897–2(b)(2) and any incorrect statement pursuant to §1.897–2(h) that arose out of such reliance would not give rise to penalties.

Example 2. The facts are the same as in Example 1, except as follows. By the time of DC's December 31, 1989 determination date, the downtown area in which DC's factory was located had become the subject of an extensive urban renewal program. On December 1, 1989, the president of DC was offered $750,000 for the factory by a developer who planned to convert the property into condominiums. Because DC thus had knowledge of the fair market value of its assets which made it clear that the corporation would probably be a U.S. real property holding corporation under the general rule of §1.897–2(b)(1), DC was not entitled to rely upon the presumption allowed by §1.897–2(b)(2) after December 1, 1989, and any false statements arising out of such reliance thereafter would give rise to penalties.

(v) *Effect on interest-holders and related persons.* For the effect on interest holders and related persons of reliance on a statement issued by a corporation that made a determination as to whether it was a U.S. real property holding corporation under the provisions of §1.897–2(b), see §§1.897–2(g)(1)(ii)(A) and 1.897–2(g)(2)(ii).

(c) *Determination dates for applying U.S. real property holding corporation*

test—(1) *In general.* Whether a corporation is a U.S. real property holding corporation is to be determined as of the following dates:

(i) The last day of the corporation's taxable year;

(ii) The date on which the corporation acquires any U.S. real property interest;

(iii) The date on which the corporation disposes of an interest in real property located outside the United States or disposes of other assets used or held for use in a trade or business during the calendar year, subject to the provisions of paragraph (c)(2)(i) of this section; and

(iv) In the case of a corporation that is treated pursuant to paragraph (d)(4) or (5) of this section as owning a portion of the assets held by an entity in which the corporation directly or indirectly holds an interest, the date on which that entity either (A) acquires a U.S. real property interest, (B) disposes of an interest in real property located outside the United States or (C) disposes of other assets used or held for use in a trade or business during the calendar year, subject to the provisions of paragraph (c)(2)(ii) of this section. A determination that is triggered by a transaction described in subdivision (ii), (iii), or (iv) of this paragraph (c)(1) must take such transaction into account. However, the first determination of a corporation's status need not be made until the 120th day after the later of the date of incorporation or of the date on which the corporation first acquires a shareholder. In addition, no determination of a corporation's status need be made during the 12-month period beginning on the date on which a corporation adopts a plan of complete liquidation, provided that all the assets of the corporation (other than assets retained to meet claims) are distributed within such period.

(2) *Transactions not requiring a determination*—(i) *Transactions by corporation.* Notwithstanding the provisions of paragraph (c)(1) of this section, a determination of U.S. real property holding corporation status need not be made on the date of:

(A) A corporation's disposition of inventory or livestock (as described in § 1.897–1(f)(1)(i) (A) and (C));

(B) The satisfaction of accounts receivable arising from the disposition of inventory or livestock or from the performance of services;

(C) The disbursement of cash to meet the regular operating needs of the business (e.g., to acquire inventory or to pay wages and salaries);

(D) A corporation's disposition of assets used or held for use in a trade or business (other than inventory or livestock) not in excess of a limitation amount determined in accordance with the rules of subdivision (iii) of this paragraph (c)(2); or

(E) A corporation's acquisition of U.S. real property interests not in excess of a limitation amount determined in accordance with the rules of subdivision (iii) of this paragraph (c)(2).

(ii) *Transactions by entity other than corporation.* Notwithstanding the provisions of paragraph (c)(1)(iv) or (c)(2)(v) of this section, in the case of a corporation that is treated as owning a portion of the assets held by an entity in which the corporation directly or indirectly holds an interest, a determination of U.S. real property holding corporation status need not be made on the date of:

(A) The entity's disposition of inventory or livestock (as described in § 1.897–1(f)(1)(i) (A) and (C));

(B) The satisfaction of accounts receivable arising from the entity's disposition of inventory or livestock or from the performance of personal services;

(C) The entity's disbursement of cash to meet the regular operating needs of its business (e.g. to acquire inventory or to pay wages and salaries);

(D) The entity's disposition of assets used or held for use in a trade or business (other than inventory or livestock) not in excess of a limitation amount determined in accordance with the rules of subdivision (iii) of this paragraph (c)(2); or

(E) The entity's acquisition of U.S. real property interests not in excess of a limitation amount determined in accordance with the rules of subdivision (iii) of this paragraph (c)(2).

(iii) *Calculation of limitation amount.* The amount of assets used or held for use in a trade or business that may be disposed of, and the amount of U.S.

real property interests that may be acquired, by a corporation or other entity without triggering a determination date shall be calculated in accordance with the following rules:

(A) If, in accordance with the provisions of paragraphs (d) and (e) of this section, a corporation on its most recent determination date was considered to hold U.S. real property interests having a fair market value that was less than 25 percent of the aggregate fair market value of all the assets it was considered to hold, then the applicable limitation amount shall be 10 percent of the fair market value of all trade or business assets or all U.S. real property interests (as applicable) held directly by the corporation or by another entity described in paragraph (c)(1)(iv) of this section on that determination date.

(B) If, in accordance with the provisions of paragraphs (d) and (e) of this section, a corporation on its most recent determination date was considered to hold U.S. real property interests having a fair market value that was equal to or greater than 25 and less than 35 percent of the aggregate fair market value of all the assets it was considered to hold, then the applicable limitation amount shall be 5 percent of the fair market value of all trade or bussiness assets or all U.S. real property interests (as applicable) held directly by the corporation or by another entity described in paragraph (c)(1)(iv) of this section on that determination date.

(C) If, in accordance with the provisions of paragraphs (d) and (e) of this section, a corporation on its most recent determination date was considered to hold U.S. real property interests having a fair market value that was equal to or greater than 35 percent of the aggregate fair market value of all the assets it was considered to hold, then the applicable limitation amount shall be 2 percent of the fair market value of all trade or business assets or all U.S. real property interests (as applicable) held directly by the corporation or by another entity described in paragraph (c)(1)(iv) of this section on that determination date.

(D) If a corporation is not a U.S. real property holding corporation under the alternative test of paragraph (b)(2) of this section (relating to the book value of the corporation's assets), then the applicable limitation shall be 10 percent of the book value of all trade or business assets or all U.S. real property interests (as applicable) held directly by the corporation or by another entity described in paragraph (c)(1)(iv) of this section on the most recent determination date.

Dispositions or acquisitions by the corporation or other entity of assets having a value less than the applicable limitation amount must be cumulated by the corporation or entity making such dispositions or acquisitions, and a determination must be made on the date of a transaction that causes the total of either type to exceed the applicable limitation. Once a determination is triggered by a transaction that causes the applicable limitation to be exceeded, the computation of the amount of trade or business assets disposed of or real property interests acquired after that date shall begin again at zero.

The rules of this paragraph (c)(2) may be illustrated by the following examples.

Example 1. DC is a domestic corporation, no class of stock of which is regularly traded on an established securities market, that knows that it has several foreign shareholders. As of December 31, 1984, DC holds U.S. real property interests with a fair market value of $500,000, no real property interests located outside the U.S. and other assets used in its trade or business with a fair market value of $1,600,000. Thus, the fair market value of DC's U.S. real property interests ($500,000) is less than 25% ($525,000) of the total ($2,100,000) of DC's U.S. real property interests ($500,000), interests in real property located outside the United States (zero), and assets used or held for use in a trade or business ($1,600,000). DC is not a U.S. real property holding corporation, and under the rule of paragraph (c)(2)(i) of this section it may dispose of trade or business assets with a fair market value equal to 10 percent ($160,000) of the total fair market value ($1,600,000) of such assets held by it on its most recent determination date (December 31, 1984), without triggering a determination of its U.S. real property holding corporation status. Therefore, when DC disposes of $60,000 worth of trade or business assets (other than inventory or livestock) on March 1, 1985, and again on April 1, 1985, no determination of its status is required on either date. However, when

DC disposes of a further $60,000 worth of such trade or business assets on May 1, its total dispositions of such assets ($180,000) exceeds its applicable limitation amount, and DC is therefore required to determine its U.S. real property holding corporation status. On May 1, 1985, the fair market value of DC's U.S. real property interests ($500,000) is greater than 25 percent ($480,000) and less than 35 percent ($672,000) of the total ($1,920,000) of DC's U.S. real property interests ($500,000), interests in real property located outside the United States (zero), and assets used or held for use in a trade or business ($1,420,000). DC is still not a U.S. real property holding corporation, but must now compute its applicable limitation amount as of the May 1 determination date. Under the rule of paragraph (c)(2)(iii)(B) of this section. DC could now dispose of trade or business assets other than inventory or livestock with a total fair market value equal to 5 percent of the fair market value of all trade or business assets held by DC on the May 1 determination date. Therefore, disposition of such trade or business assets with a fair market value of more than $71,000 (5 percent of $1,420,000) will trigger a further determination date for DC.

Example 2. DC is a domestic corporation, no class of stock of which is regularly traded on an established securities market, that knows that it has several foreign shareholders. As of December 31, 1986, DC's only assets are a U.S. real property interest with a fair market value of $300,000 other assets used or held for use in its trade or business with a fair market value of $600,000, and a 50 percent partnership interest in domestic partnership DP. DC's interest in DP constitutes a percentage ownership interest in the partnership of 50 percent, and pursuant to the rules of paragraph (e)(2) of this section DC is treated as owning a portion of the assets of DP determined by multiplying that percentage by the fair market value of DP's assets. As of December 31, 1986, DP's only assets are U.S. real property interests with a fair market value of $120,000 and other assets used in its trade or business with a fair market value of $380,000. As of its December 31, 1986, determination date, the fair market value ($360,000) of the U.S. real property interests DC holds ($300,000) and is treated as holding ($80,000 [The fair market value of DP's U.S. real property interest ($120,000) multiplied by DC's percentage ownership interest in DP (50 percent)]), is equal to 31 percent of the sum of the fair market values ($1,150,000) of the U.S. real property interests DC holds and is treated as holding ($360,000) DC's interest in real property located outside the United States (zero), and assets used or held for use in a trade or business that DC holds or is treated as holding ($790,000 [$600,000 (held directly) plus $190,000 (DC's 50 percent share of assets used or held for use in a trade or business by DP)]). Thus, under the rules of paragraph (c)(2) (i) and (iii)(B) of this section DC may dispose of assets used or held for use in its trade or business with a fair market value equal to 5 percent ($30,000) of the total fair market value ($600,000) of such assets held directly by it on its most recent determination date (December 31, 1986), without triggering a determination of its U.S. real property holding corporation status. In addition, under the rules of paragraph (c)(2) (ii) and (iii)(A) of this section, a determination date for DC would not be triggered by DP's disposition of trade or business assets (other than inventory or livestock) with a fair market value equal to 5 percent ($19,000) of the total fair market value ($380,000) of such assets held by it as of DC's most recent determination date (December 31, 1986). However, any disposition of such assets by DP exceeding that limitation would trigger a determination of DC's U.S. real property holding corporation status. In addition under the rule of paragraph (c)(1)(iv) of this section, any disposition of a U.S. real property interest by DP would trigger a determination date for DC, while under the rule of paragraph (c)(2)(ii) of this section no disposition of inventory or livestock by DP would trigger a determination for DC.

(3) *Alternative monthly determination dates*—(i) *In general.* Notwithstanding the provisions of paragraphs (c) (1) and (2) of this section, a corporation may choose to determine its U.S. real property holding corporation status in accordance with the rules of this paragraph (c)(3). In the case of a corporation that has determined that it is not a U.S. real property holding corporation pursuant to the alternative test of paragraph (b)(2) of this section (relating to the book value of the corporation's assets), the rules of this paragraph (c)(3) may be applied by using book values rather than fair market values in all relevant calculations.

(ii) *Monthly determinations.* A corporation that determines its U.S. real property holding corporation status in accordance with the rules of this paragraph (c)(3) must make a determination at the end of each calendar month.

(iii) *Transactional determinations.* A corporation that determines its U.S. real property holding corporation status in accordance with the rules of this paragraph (c)(3) must make a determination as of the date on which, pursuant to a single transaction (consisting of one or more transfers):

(A) U.S. real property interests are acquired, and/or

(B) Interests in real property located outside the U.S. and/or assets used or held for use in a trade or business are disposed of,

if the total fair market value of the assets acquired and/or disposed of exceeds 5 percent of the sum of the fair market values of the U.S. real property interests, interests in real property located outside the U.S., and assets used or held for use in a trade or business held by the corporation.

(iv) *Exceptions*. Notwithstanding any other provision of this paragraph (c)(3), the first determination of a corporation's status need not be made until the 120th day after the later of the date of incorporation or the date on which the corporation first acquires a shareholder. In addition, no determination of a corporation's status need be made during the 12-month period beginning on the date on which a corporation adopts a plan of complete liquidation, if all the assets of the corporation (other than assets retained to meet claims) are distributed within such period.

(4) *Valuation date methods*—(i) *In general*. For purposes of determining whether a corporation is a U.S. real property holding corporation on any applicable determination date, the fair market value of the assets held by the corporation (in accordance with § 1.897–2(d)) as of that determination date must be used.

(ii) *Alternative valuation date method for determination dates other than the last day of the taxable year*. For purposes of paragraph (c)(4)(i) of this section, if an applicable determination date under paragraph (c) (1), (2), or (3) of this section is other than the last day of the taxable year, property may be valued as of the later of the last day of the previous taxable year or the date such property was acquired. For purposes of the determination date that falls on the last day of the taxable year, fair market value as of that date must always be used.

(iii) *Consistent methods*. The valuation date method selected under this paragraph (c)(4) for the first determination date in a taxable year must be used for all subsequent determination dates for such year. In addition, the valuation date method selected must be used for all property with respect to which the determination is made. The use of one method for one taxable year does not preclude the use of the other method for any other taxable year.

(5) *Illustrations*. The rules of this paragraph (c) are illustrated by the following examples:

Example 1. Nonresident alien individual C purchased 100 shares of stock of domestic corporation K on July 26, 1985. Although K has additional shares of common stock outstanding, its stock has never been traded on an established securities market. At all times during calendar year 1985, K's only assets were a parcel of U.S. real estate (parcel A) and a parcel of country Z real estate (parcel B). On December 31, 1985, the fair market value of parcel A was $1,000,000 and the fair market value of parcel B was $2,000,000. For purposes of determining whether K was a U.S. real property holding corporation during 1985, the only applicable determination date was December 31, 1985, because K did not make any acquisitions or dispositions described in paragraph (c)(1) of this section during the year. The test of paragraph (b) of this section is applied using the fair market value of the property held on that date. K was not a U.S. real property holding corporation during 1985 because as of December 31, 1985, the fair market value ($1,000,000) of the U.S. real property interests held by K did not equal or exceed 50 percent ($1,500,000) of the sum ($3,000,000) of the fair market value of K's U.S. real property interest ($1,000,000), the interests in real property located outside the United States ($2,000,000), plus other assets used or held for use by K in a trade or business (zero).

Example 2. The facts are the same as in example 1, except that on April 7, 1986, K purchased another parcel of U.S. real estate for $2,000,000. K's purchase of real property on April 7 triggered a determination on that date. As provided in paragraph (c)(3)(ii) of this section, K chooses to use the value of parcels A and B as of the previous December 31, while newly acquired parcel C must be valued as of its acquisition on April 7, 1986. On that date, K qualifies as a U.S. real property holding corporation, since the fair market value of its U.S. real property interests ($3,000,000) exceeds 50 percent ($2,500,000) of the sum ($5,000,000) of the fair market value of K's U.S. real property interests ($3,000,000), its interests in real property located outside the U.S. ($2,000,000), and its other assets used or held for use in a trade or business (zero).

(d) *Assets held by a corporation*. The assets that must be included in the determination of whether a corporation is a U.S. real property holding corporation are the following:

(1) U.S. real property interests that are held directly by the corporation (including directly-held interests in foreign corporations that are treated as U.S. real property interests pursuant to the rules of paragraph (e)(1) of this section);

(2) Interests in real property located outside the United States that are held directly by the corporation;

(3) Assets used or held for use in a trade or business that are held directly by the corporation;

(4) A proportionate share of assets held through a partnership, trust, or estate pursuant to the rules of paragraph (e)(2) of this section; and

(5) A proportionate share of assets held through a domestic or foreign corporation in which a corporation holds a controlling interest, pursuant to the rules of paragraph (e)(3) of this section.

(e) *Special rules regarding assets held by a corporation*—(1) *Interests in foreign corporations*. For purposes only of determining whether any corporation is a U.S. real property holding corporation, an interest in a foreign corporation shall be treated as a U.S. real property interest unless it is established that the interest was not a U.S. real property interest under the rules of this section on the applicable determination date. The rules of paragraph (g)(2) of this section must be complied with to establish that the interest is not a U.S. real property interest. However, regardless of whether an interest in a foreign corporation is treated as a U.S. real property interest for this purpose, gain or loss from the disposition of an interest in such corporation will not be treated as effectively connected with the conduct of a U.S. trade or business by reason of section 897(a). The rules of this paragraph (e)(1) are illustrated by the following examples. In each example, fair market value is determined as of the applicable determination dates under paragraph (c)(4)(i) of this section.

Example 1. Nonresident alien individual F holds all of the stock of domestic corporation DC. DC's only assets are 40 percent of the stock of foreign corporation FC, with a fair market value of $500,000, and a parcel of country W real estate, with a fair market value of $400,000. Foreign corporation FP, unrelated to DC, holds the other 60 percent of the stock of FC. FC's only asset is a parcel of U.S. real estate with a fair market value of $1,250,000. FC is a U.S. real property holding corporation because the fair market value of its U.S. real property interests ($1,250,000) exceeds 50 percent ($625,000) of the sum of the fair market values of its U.S. real property interests ($1,250,000), its interests in real property located outside the United States (zero), plus its other assets used or held for use in a trade or business (zero). Consequently DC's interest in FC is treated as a U.S. real property interest under the rules of this paragraph (e)(1). DC is a U.S. real property holding corporation because the fair market value ($500,000) of its U.S. real property interest (the stock of FC) exceeds 50 percent ($450,000) of the sum ($900,000) of the fair market value of its U.S. real property interests ($500,000), its interests in real property located outside the United States ($400,000), plus its other assets used or held for use in a trade or business (zero). If F disposes of her stock within 5 years of the current determination date, her gain or loss on the disposition of her stock in DC will be treated as effectively connected with a U.S. trade or business under section 897(a). However, FP's gain on the disposition of its FC stock would not be subject to the provisions of section 897(a) because the stock of FC is a U.S. real property interest only for purposes of determining whether DC is a U.S. real property holding corporation.

Example 2. Nonresident alien individual B holds all of the stock of domestic corporation US. US's only assets are 40 percent of the stock of foreign corporation FC1. Nonresident alien individual N, unrelated to US, holds the other 60 percent of FC1's stock. FC1's only assets are 40 percent of the stock of foreign corporation FC2. The remaining 60 percent of the stock of FC2 is owned by nonresident alien individual X, who is unrelated to FC1. FC2's only asset is a parcel of U.S. real estate with fair market value of $1,000,000. FC2, therefore, is a U.S. real property holding corporation, and the stock of FC2 held by FC1 is a U.S. real property interest for purposes of determining whether FC1 is a U.S. real property holding corporation (but not for purposes of treating FC1's gain from the disposition of FC2 stock as effectively connected with a U.S. trade or business under section 897(a)). As all of FC1's assets are U.S. real property interests, the stock of FC1 held by US is a U.S. real property interest for purposes of determining whether US is a U.S. real property holding corporation (but not for purposes of subjecting N's gain on the disposition of FC1 stock to the provisions of section 897(a)). As US is a domestic corporation and as all of its assets are U.S. real property interests, US is a U.S. real property holding corporation, and the stock of US held by B is a U.S. real property interest for purposes of section 897(a)).

Therefore, B's gain or loss upon the disposition of the stock of US within 5 years of the most recent determination date is subject to the provisions of section 897(a).

(2) Proportionate ownership of assets held by partnerships, trusts, and estates. For purposes of determining whether a corporation is a U.S. real property holding corporation, a holder of an interest in a partnership, a trust, or an estate (whether domestic or foreign) shall be treated pursuant to section 897(c)(4)(B) as holding a proportionate share of the assets held by the entity.

However, a holder of an interest shall not be treated as holding a proportionate share of assets that in the hands of the entity are subject to the rule of § 1.897–1(f)(3)(ii) (concerning the trade or business assets of investment companies). Such proportionate share is to be determined in acordance with the rules of § 1.897–1(e) on each applicable determination date. The interest in the entity shall itself be disregarded when a proportionate share of the entity's assets is attributed to the interestholder pursuant to the rule of this paragraph (e)(2). Any asset treated as held by a holder of an interest by reason of this paragraph (e)(2) which is used or held for use in a trade or business by the partnership, trust, or estate shall be treated as so used or held for use by the holder of the interest. The proportionate ownership rule of this paragraph (e)(2) applies successively upward through a chain of ownership. The proportionate ownership rule of this paragraph (e)(2) is illustrated by the following examples. In each example fair market value is determined as of the applicable determination date under paragraph (c)(4)(i) of this section.

Example 1. Nonresident alien individual F holds all of the stock of domestic corporation DC. DC is a partner in foreign partnership FP, and DC's percentage ownership interest in FP is 50 percent. DC's other assets are a parcel of country F real estate with a fair market value of $500,000 and other assets which it uses in its business with a fair market value of $100,000, FP's assets are a parcel of country Z real estate with a fair market value of $300,000 and a parcel of U.S. real estate with a fair market value of $2,000,000. For purposes of determining whether DC is a U.S. real property holding corporation, DC is treated as holding its pro rata share of the assets held by FP. DC's pro rata share of the U.S. real estate held by FP is $1,000,000, determined by multiplying the fair market value ($2,000,000) of the U.S. real property interests held by FP by DC's percentage ownership interest in FP (50 percent). DC's pro rata share of the country Z real estate held by FP is $150,000, determined in the same manner. DC is a U.S. real property holding corporation because the fair market value ($1,000,000) of its U.S. real property interests (the U.S. real estate it is treated as holding proportionately) exceeds 50 percent ($875,000) of the sum ($1,750,000) of the fair market value of its U.S. real property interests ($1,000,000), its interests in real property located outside the United States [($650,000) (its country F real estate and its pro rata share of the country Z real estate)], plus its other assets which are used or held for use in a trade or business ($100,000). Because DC is a domestic U.S. real property holding corporation, the stock of DC is a U.S. real property interest and F's gain or loss on the disposition of this DC stock within 5 years of the current determination date will be treated as effectively connected with a U.S. trade or business under section 897(a).

Example 2. Nonresident alien individual B holds all of the stock of domestic corporation US. US is a beneficiary of foreign trust FT. US's percentage ownership interest in FT is 90 percent. US has no other assets. FT is a partner in domestic partnership DP. FT's percentage ownership interest in DP is 30 percent. FT has no other assets. DP's only asset is a parcel of U.S. real estate with a fair market value of $1,000,000. FT is treated as holding U.S. real estate with a fair market value of $300,000 (30 percent of the U.S. real estate held by DP with a fair market value of $1,000,000). For purposes of determining whether US is a U.S. real property holding corporation, the proportionate ownership rule is applied successively upward through the chain of ownership. Thus, US is treated as holding 90 percent of FT's $300,000 pro rata share of the U.S. real estate held by DP. US is a U.S. real property holding corporation because the fair market value ($270,000) of its U.S. real property interests (its pro rata share of the U.S. real estate held by DP) exceeds 50 percent ($135,000) of the sum of the fair market values of its U.S. real property interests ($270,000), its interests in real property located outside the United States (zero), plus its other assets used or held for use in a trade or business (zero). Because US is a domestic U.S. real property holding corporation, the stock of US is a U.S. real property interest, and B's gain or loss from the disposition of US stock within 5 years of the current determination date will be treated as effectively connected with a U.S. trade or business under section 807(a).

(3) *Controlling interests in corporations.* For purposes only of determining whether a corporation is a U.S. real property holding corporation, if the corporation (the ''first corporation'') holds a controlling interest in a second corporation—

(i) The first corporation is treated as holding a proportionate share of each asset (i.e., U.S. real property interests, interests in real property located outside the United States, and assets used or held for use in a trade or business) held by the second corporation, determined in accordance with the rules of § 1.897–1(e);

(ii) Any asset so treated as held proportionately by the first corporation which is used or held for use by the second corporation in a trade or business shall be treated as so used or held for use by the first corporation; and

(iii) Interests in the second corporation held by the first corporation are not themselves taken into account as U.S. real property interests (regardless of whether the second corporation is a U.S. real property holding corporation) or as trade or business assets. However, the first corporation shall not be treated as holding a proportionate share of assets that in the hands of the second corporation are subject to the rules of § 1.897–1(f)(3)(ii) (concerning the trade or business assets of investment companies). A determination of what portion of the assets of the second corporation are considered to be held by the first corporation shall be made as of the applicable dates for determining whether the first corporation is a U.S. real property holding corporation.

A ''controlling interest'' means 50 percent or more of the fair market value of all classes of stock of the corporation, determined as of the applicable determination date. In determining whether a corporation holds a controlling interest in another corporation, section 318(a) shall apply (except that sections 318(a)(2)(C) and (3)(C) are applied by substituting the phrase ''5 percent'' for ''50 percent''). However, a corporation that does not directly hold any interest in a second corporation shall not be treated as holding a controlling interest in the second corporation by reason of the application of section 318(a)(3)(C). The rules of this paragraph (e)(3) apply successively upward through a chain of ownership. For example, if the second corporation owns a controlling interest in a third corporation, the rules of this paragraph shall be applied first to determine the portion of the assets of the third corporation that is considered to be held by the second corporation and then to determine the portion of the assets held and considered to be held by the second corporation that is considered to be held by the first corporation. The controlling interest rules of this paragraph (e)(3) apply, regardless of whether a corporation is domestic or foreign, whenever it is necessary to determine whether a corporation is a U.S. real property holding corporation. The rules of this paragraph (e)(3) are illustrated by the following examples. In each example fair market value is determined as of the applicable determination date under paragraph (c)(4)(i) of this section and no corporation holds constructively any interest not specified in the example.

Example 1. Nonresident alien individual N owns all of the stock of domestic corporation DC. DC's only assets are 60 percent of the fair market value of all classes of stock of foreign corporation FS and 60 percent of the fair market value of all classes of stock of domestic corporation DS. The percentage ownership interest of DC in each of FS and DS is 60 percent. The balance of the stock in FS and DS is held by nonresident alien individual B, who is unrelated to DC. FS's only asset is a parcel of country F real estate with a fair market value of $1,000,000. DS's only asset is a parcel of U.S. real estate with a fair market value of $2,000,000. The value of DC stock in FS and DS is not taken into account for purposes of determining whether DC is a U.S. real property holding corporation. Rather, because DC holds a controlling interest (60 percent) in each of FS and DS, DC is treated as holding a portion of each asset held by FS and DS. DC's portion of the country F real estate held by FS is $600,000, determined by multiplying the fair market value ($1,000,000) of the country F real estate by DC's percentage ownership interest (60 percent). Similarly, DC's portion of the U.S. real estate held by DS is $1,200,000 (60 percent of $2,000,000). DC is a U.S. real property holding corporation, because the fair market value ($1,200,000) of its U.S. real property interests (its portion of the U.S. real estate) exceeds 50 percent ($900,000) of the sum ($1,800,000) of the fair market values of its U.S. real property interests ($1,200,000), its interests in real property located outside the

United States (the $600,000 portion of country F real estate), plus its other assets used or held for use in a trade or business (zero). Because DC is a domestic U.S. real property holding corporation, the stock of DC is a U.S. real property interest, and N's gain or loss on the disposition of DC stock within 5 years of the current determination date would be treated as effectively connected with a U.S. trade or business under section 897(a).

Example 2. (i) Nonresident alien individual F owns all of the stock of domestic corporation US1. US1's only asset is 85 percent of the fair market value of all classes of stock of domestic corporation US2. US2's only assets are 60 percent of the fair market value of all classes of stock of domestic corporation US3, with a fair market value of $600,000, and a parcel of country D real estate with a fair market value of $800,000. US3's only asset is a parcel of U.S. real estate with a fair market value of $2,000,000. The percentage ownership interest of F in US1 is 100 percent.

Although US1 owns 85 percent of the stock of US2, US1's percentage ownership interest in US2 is 75 percent, because US2 has other interests other than solely as a creditor outstanding. US2's percentage ownership interest in US3 is 60 percent.

(ii) US2 holds a controlling interest in US3, since it holds more than 50 percent of the fair market value of all classes of stock of US3. Consequently, the value of US2's stock in US3 is not taken into account in determining whether US2 is a U.S. real property holding corporation, even though US3 is a U.S. real property holding corporation. Instead, US2 is treated as holding a portion of the U.S. real estate held by US3. US2's portion of the U.S. real estate is $1,200,000, determined by multiplying US2's percentage ownership interest (60 percent) by the fair market value ($2,000,000) of the U.S. real estate. US1 holds a controlling interest in US2 (75 percent.). By reapplying the rules of paragraph (e)(3) of this section successively upward through the chain of ownership, US1's stock in US2 is not taken into account, and US1 is treated as holding a portion of the country D real estate held by US2 and the U.S. real estate which US2 is treated as holding proportionately. US1's portion of the country D real estate is $600,000, determined by multiplying US1's percentage ownership interest (75 percent) by the fair market value ($800,000) of the country D real estate. US1's portion of the U.S. real estate which US2 is treated as owning is $900,000, determined by multiplying US1's percentage ownership interest (75 percent) by the fair market value ($1,200,000) of US2's portion of U.S. real estate held by US3. US1 is a U.S. real property holding corporation, because the fair market value ($900,000) of its U.S. real property interests (its portion of US2's portion of U.S. real estate) is more than 50 percent ($750,000) of the sum ($1,500,000) of fair market values of its U.S. real property interests ($900,000), its interests in real property located outside the United States ($800,000), plus its other assets need or held for use in a trade or business (zero). Because US1 is a U.S. real property holding corporation and is a domestic corporation, the stock of US1 is a U.S. real property interest, and F's gain or loss on the disposition of US1 stock within 5 years of the current determination date will be treated as effectively connected with a U.S. trade or business under section 897(a).

Example 3. Nonresident alien individual B holds all of the stock of domestic corporation DC. DC's only assets are 40 percent of the fair market value of all classes of stock of foreign corporation FC and a parcel of country R real estate with a fair market value of $100,000. FC's only asset is one parcel of U.S. real estate with a fair market value of $1,000,000. The fair market value of the FC stock held by DC is $200,000. FC is a U.S. real property holding corporation. Since DC does not hold a controlling interest in FC, the controlling interest rules of paragraph (e)(3) of this section do not apply to treat DC as holding a portion of the U.S. real estate held by FC. However, because FC is a U.S. real property holding corporation, the stock of FC is a U.S. real property interest for purposes of determining whether DC is a U.S. real property holding corporation. DC is a U.S. real property holding corporation because the fair market value ($200,000) of its U.S. real property interest (the stock of FC) exceeds 50 percent ($150,000) of the sum ($300,000) of the fair market values of its U.S. real property interest ($200,000), its interests in real property located outside the United States ($100,000), plus its other assets used or held for use in a trade or business (zero). Because DC is a U.S. real property holding corporation and is a domestic corporation, its stock is a U.S. real property interest, and B's gain or loss on the disposition of DC stock within 5 years of the current determination date would be subject to the provisions of section 897(a).

Example 4. Nonresident alien individual C owns all of the stock of domestic corporation DC1. DC1's only assets are 25 percent of the fair market value of all classes of stock of domestic corporation DC2, and a parcel of U.S. real estate with a fair market value of $100,000. The stock of DC2 is not an asset used or held for use in DC1's trade or business. DC2's only assets are a building located in the U.S. with a fair market value of $100,000 and manufacturing equipment and inventory with a fair market value of $200,000, DC2 is not a U.S. real property holding corporation. Since DC1 does not hold a controlling interest in DC2, the rules of this paragraph (e)(3) do not apply to treat DC1 as

holding a portion of the assets held by DC2. In addition, since DC2 is not a U.S. real property corporation, its stock does not constitute a U.S. real property interest. Therefore, for purposes of determining whether DC1 is a real property holding corporation, its interest in DC2 is not taken into account. Since DC1's only other asset is a parcel of U.S. real estate, DC1 is a U.S. real property holding corporation, and C's gain or loss on the disposition of DC1 stock within 5 years of the current determination date would be subject to the provisions of section 897(a).

(4) *Co-application of rules of this paragraph (e).* The rules of this paragraph (e) apply in conjunction with one another for purposes of determining whether a corporation is a U.S. real property holding corporation. The rule of this paragraph (e)(4) is illustrated by the following example. In the example fair market value is determined as of the applicable determination date in accordance with paragraph (c)(4)(i) of this section.

Example. Nonresident alien individual B holds 100 percent of the stock of domestic corporation US. US's only asset is 10 percent of the stock of foreign corporation FC1. FC1's only asset is 100 percent of the stock of foreign corporation FC2. FC2's only asset is a 50 percent interest in domestic partnership DP. FC2's percentage ownership interest in DP is 50 percent. DP's only asset is a parcel of U.S. real estate with a fair market value of $10,000,000. In determining whether US is a U.S. real property holding corporation, the rules of this paragraph (e) apply in conjunction with one another. Consequently, under paragraph (e)(2) of the section FC2 is treated as holding U.S. real estate with a fair market value of $5,000,000 (50 percent of $10,000,000, its pro rata share of real estate held by DP). Under paragraph (e)(3) of this section, FC1 is treated as holding 100 percent of the assets of FC2 (U.S. real estate with a fair market value of $5,000,000). FC1, therefore, is a U.S. real property holding corporation. Under paragraph (e)(1) of this section, the stock of FC1 is treated as U.S. real property interest. US is a U.S. real property holding corporation because 100 percent of its assets (the stock of FC1) are U.S. real property interests. As US is a U.S. real property holding corporation and is a domestic corporation, the stock of US is a U.S. real property interest, and B's gain or loss from the disposition of stock of US within 5 years of the current determination date will be subject to the provisions of section 897(a).

(f) *Termination of U.S. real property holding corporation status*—(1) *In general.* A U.S. real property holding corporation may voluntarily determine its status as of the date of any acquisition or disposition of assets. If the fair market value of its U.S. real property interests on such date no longer equals or exceeds 50 percent of the fair market value of all assets described in paragraphs (d) and (e) of this section, such corporation shall cease to be U.S. real property holding corporation as of such date, and on the day that is five years after such date interests in such corporation shall cease to be treated as U.S. real property interests (unless subsequent transactions within the five-year period have caused the fair market value of the corporation's U.S. real property interests to equal or exceed 50 percent of the fair market value of assets described in paragraphs (d) and (e) of this section). A corporation that determines that interests in it have ceased to be U.S. real property interests pursuant to the rules of this paragraph (f) may so inform the Internal Revenue Service, as provided in paragraph (h) of this section.

(2) *Early termination.* Interests in a U.S. real property holding corporation shall immediately cease to be U.S. real property interests as of the first date on which the following conditions are met—

(i) The corporation does not hold any U.S. real property interests;

(ii) All of the U.S. real property interests directly or indirectly held by such corporation at any time during the previous five years (but disregarding any disposed of before June 19, 1980) either (A) were directly of indirectly disposed of in transactions in which the full amount of the gain (if any) was recognized or (B) ceased to be U.S. real property interests by reason of the application of this paragraph (f) to one or more other corporations; and

(iii) If the disposition occurs on or after December 18, 2015, neither the corporation nor any predecessor of the corporation was a regulated investment company or a real estate investment trust at any time during the shorter of the periods described in section 897(c)(1)(A)(ii).

For purposes of this paragraph (f)(2), a corporation that disposes of all U.S. real property interests other than a lease that has a fair market value of

zero will be considered to have disposed of all of its U.S. real property interests, provided that the leased property is used in the conduct by the corporation of a trade or business in the United States. Such a lease may include an option to renew, but only if such option is for a renewal at fair market rental rates prevailing at the time of renewal.

(g) *Establishing that a corporation is not a U.S. real property holding corporation*—(1) *Foreign persons disposing of interests*—(i) *In general.* A foreign person disposing of an interest in a domestic corporation (other than an interest solely as a creditor) must establish that the interest was not a U.S. real property interest as of the date of disposition, either by:

(A) Obtaining a statement from the corporation pursuant to the provisions of subdivision (ii) of this paragraph (g)(1), or

(B) Obtaining a determination by the Commissioner, Small Business/Self Employed Division (SB/SE) pursuant to the provisions of subdivision (iii) of this paragraph (g)(1).

If the foreign person does not establish by either method that the interest disposed of was not a U.S. real property interest then the interest shall be presumed to have been a U.S. real property interest the disposition of which is subject to section 897(a). See paragraph (g)(3) of this section for certain exceptions to this rule. It should be noted that the rules of this section relate solely to interests in a corporation that are interests other than solely as a creditor. Therefore, a statement by a corporation or a determination by the Commissioner (under paragraphs (g) or (h) of this section) that an interest is not a U.S. real property interest depends solely upon whether or not the corporation was a U.S. real property holding corporation during the period described in section 897(c)(1)(A)(ii) (subject to certain special rules). The determination of whether an interest is one solely as a creditor is made under the rules of § 1.897–1(d).

(ii) *Statement from corporation*—(A) *In general.* A foreign person disposing of an interest in a domestic corporation may establish that the interest was not a U.S. real property interest as of the date of the disposition by requesting and obtaining from the corporation a statement that the interest was not a U.S. real property interest as of that date. However, a corporation's statement shall not be valid for purposes of this rule, and thus may not be relied upon for purposes of establishing that an interest was not a U.S. real property interest, unless the corporation complies with the notice requirements of paragraph (h) (2) or (h)(4) of this section.

A foreign person that requests and obtains such a statement is not required to forward the statement to the Internal Revenue Service and is not required to take any further action to establish that the interest disposed of was not a U.S. real property interest. To qualify under this rule, the foreign person must obtain the corporation's statement no later than the date, including any extensions, on which a tax return would otherwise be due with respect to a disposition. A foreign person that relies in good faith upon a statement from the corporation is not thereby excused from filing a return and paying any taxes and interest due thereon if the corporation's statement is later found to have been incorrect. However, such reliance shall be taken into account in determining whether the foreign person shall be subject to any penalty for the previous failure to file. However, a foreign person that knew or had reason to know that a corporation's statement was incorrect is not entitled to rely upon such statement and shall remain liable for all applicable penalties.

(B) *Coordination with section 1445.* Pursuant to section 1445 and regulations thereunder, withholding of tax is not required with respect to a foreign person's disposition of an interest in a domestic corporation, if the transferee is furnished with a statement by the corporation under paragraph (h) of this section that the interest is not a U.S. real property interest. A foreign person that obtains a corporation's statement for that purpose prior to the date of disposition may also rely upon the statement for purposes of this paragraph (g)(1)(ii), unless the corporation informs the foreign person (pursuant to paragraph (h)(1)(iv)(C) of this section)

that it became a U.S. real property holding corporation after the date of the notice but prior to the actual date of disposition.

(iii) *Determination by Commissioner*—(A) *In general.* A foreign person disposing of an interest in a domestic corporation may establish that the interest was not a U.S. real property interest as of the date of disposition by requesting and obtaining a determination to that effect from the Commissioner. Such a determination may be requested pursuant to the provisions of subdivision (B) or (C) of this paragraph (g)(1)(iii). A request for a determination should be addressed to: Commissioner, Small Business/Self Employed Division (SB/SE); S C3–413 NCFB, 500 Ellin Road, Lanham, MD 20706. A foreign transferor who has requested a determination by the Commissioner pursuant to the rules of this paragraph (g)(1)(iii) is not thereby excused from filing a return and paying any tax due by the date, including any extensions, on which such return and payment would otherwise be due with respect to a disposition. If the Commissioner subsequently determines and notifies the foreign transferor that the interest was not a U.S. real property interest, the foreign transferor shall be entitled to a refund of any taxes, penalties, and interest paid by reason of the application of section 897(a) pursuant to the rules of paragraph (g)(1)(i) of this section, together with any interest otherwise due on such refund, if a claim for refund is made within the applicable time limits.

(B) *Determination based on Commissioner's information.* A foreign person may request that the Commissioner make a determination based on information contained in the Commissioner's records, if:

(*1*) The foreign person made a request to the corporation for information as to the status of its interest no later than the 90th day before the date, including any extensions, on which a tax return would otherwise be due with respect to a disposition, and

(*2*) The corporation failed to respond to such request by the 30th day following the date the request was delivered to the corporation.

If the Commissioner is unable to make a determination based on information available to him, he shall inform the foreign person that the interest must be treated as a U.S. real property interest unless the person subsequently obtains either the necessary statement from the corporation or a determination pursuant to subdivision (C) of this paragraph (g)(1)(iii).

(C) *Determination based on information supplied by foreign person.* A foreign person may request that the Commissioner make a determination based on information supplied by the foreign person. Such information may be drawn, for example, from annual reports, financial statements, or records of the corporation, and must establish to the satisfaction of the Commissioner that the foreign person's interest was not a U.S. real property interest as of the date of disposition.

(D) *Determination by Commissioner on his own motion.* Notwithstanding any other provision of this section, a foreign person shall not treat the disposition of an interest in a domestic corporation as a disposition of a U.S. real property interest if such person is notified that the Commissioner has upon his own motion determined that the interest was not a U.S. real property interest as of the date of disposition.

(2) *Corporations determining U.S. real property holding corporation status*—(i) *In general.* A corporation that must determine whether it is a U.S. real property holding corporation, and that holds an interest in another corporation (other than a controlling interest as defined in paragraph (e)(3) of this section), must determine whether or not that interest was a U.S. real property interest as of its own determination date, by either:

(A) Obtaining a statement from the second corporation pursuant to the provisions of subdivision (ii) of this paragraph (g)(2);

(B) Obtaining a determination by the Commissioner pursuant to the provisions of subdivision (iii) of this paragraph (g)(2); or

(C) Making an independent determination pursuant to the provisions of subdivision (iv) of this paragraph (g)(2).

A corporation that is unable to determine by any of the above methods

whether its interest in a second corporation is a U.S. real property interest must presume that such interest is a U.S. real property interest.

(ii) *Statement from corporation.* A corporation may determine whether or not an interest in a second corporation was a U.S. real property interest as of its own determination date by obtaining from the second corporation a statement that the interest was not a U.S. real property interest as of that date. However, the second corporation's statement shall not be valid for purposes of this rule, and thus may not be relied upon for purposes of establishing that an interest was not a U.S. real property interest, unless such corporation complies with the notice requirements of paragraph (h)(2) or (h)(4) of this section.

A corporation that requests and obtains such a statement is not required to forward the statement to the Internal Revenue Service and is not required to take any further action to establish that the interest in the second corporation was not a U.S. real property interest. If the second corporation's statement is later found to have been incorrect, the first corporation shall not be subject to penalties arising out of past failures to comply with the requirements of section 897 or 1445, if such failures were attributable to reliance upon the second corporation's statement. By the 90th day following receipt of a notification from the Service or from the second corporation that a prior statement was incorrect, the first corporation must redetermine its status (as of its most recent determination date) and if appropriate notify the Internal Revenue Service that it is a U.S. real property holding corporation in accordance with paragraph (h)(1)(ii)(C) of this section. However, a corporation that knew or had reason to know that a second corporation's statement was incorrect is not entitled to rely upon such statement and shall remain liable for all applicable taxes, penalties, and interest arising out of the second corporation's status as a U.S. real property holding corporation.

(iii) *Determination by Commissioner*—(A) *In general.* A corporation may determine whether or not an interest in a second corporation was a U.S. real property interest as of its own determination date by requesting and obtaining a determination to that effect from the Commissioner. Such a determination may be requested pursuant to the provisions of subdivision (B) or (C) of this paragraph (g)(2)(iii). A request for a determination must be addressed to: Commissioner, Small Business/Self Employed Division (SB/SE); S C3–413 NCFB, 500 Ellin Road, Lanhan, MD 20706. A corporation that has requested a determination by the Commissioner pursuant to the provisions of this paragraph is not thereby excused from taking any action required by section 897 or 1445 by the date on which such action would otherwise be due. However, the Commissioner may grant a reasonable extension of time for the satisfaction of any requirement if the Commissioner is satisfied that the corporation has not sought a determination pursuant to this paragraph (g)(2)(iii) for a principal purpose of delay.

(B) *Determination based on Commissioner's information.* A corporation may request that the Commissioner make a determination based on information contained in the Commissioner's records, if:

(*1*) The corporation made a request to the second corporation for information as to the status of its interest no later than the fifth day following the first corporation's determination date, and

(*2*) The second corporation failed to respond to such request by the 30th day following the date the request was delivered to the second corporation.

Pending his resolution of such a request, the Commissioner will generally grant an extension with respect to the change-of-status notification that may otherwise be required pursuant to paragraph (h)(1)(ii) of this section. If the Commissioner is unable to make a determination based on information available to him, he shall inform the corporation that the interest must be treated as a U.S. real property interest unless the corporation subsequently obtains either the necessary statement from the second corporation or a determination pursuant to paragraph (g)(2)(iii)(C) or (g)(2)(iv) of this section.

(C) *Determination based on information supplied by corporation.* A corporation may request that the Commissioner

make a determination based on information supplied by the corporation. Such information may be drawn, for example, from annual reports, financial statements, or records of the second corporation, and must establish to the satisfaction of the Commissioner that the interest in the second corporation was not a U.S. real property interest as of the first corporation's determination date.

(D) *Determination by Commissioner on his own motion.* Notwithstanding any other provision of this section, a corporation shall not treat an interest in a second corporation as a U.S. real property interest if the corporation is notified that the Commissioner has upon his own motion determined that the interest in the second corporation is not a U.S. real property interest.

(iv) *Independent determination by corporation.* A corporation may independently determine whether or not an interest in a second corporation was a U.S. real property interest as of the first corporation's own determination date. Such determination must be based upon the best evidence available, drawn from annual reports, financial statements, records of the second corporation, or from any other source, that demonstrates to a reasonable certainty that the interest in the second corporation was not a U.S. real property interest. A corporation that makes an independent determination pursuant to this paragraph (g)(2)(iv) shall be subject to the special notification rule of paragraph (h)(1)(iii)(D) of the section. If the Commissioner subsequently determines that the corporation's independent determination was incorrect, the corporation shall be subject to penalties for any past failure to comply with the requirements of section 897 or 1445 only if the corporation's determination was unreasonable in view of facts that the corporation knew or had reason to know.

(3) *Requirements not applicable.* If at any time during the calendar year any class of stock of a corporation is regularly traded on an established securities market, the requirements of this paragraph (g) shall not apply with respect to any holder of an interest in such corporation other than a person who holds an interest described in § 1.897–1(c)(2)(iii) (A) or (B). For example, a corporation determining whether it is a U.S. real property holding corporation need not ascertain from a regularly traded corporation in which it neither holds, nor has held during the period described in section 897(c)(1)(A)(ii), more than a 5 percent interest whether that regularly traded corporation is itself a U.S. real property holding corporation.

In addition, the requirements of this paragraph (g) do not apply to any holder of an interest in a domestically-controlled RETT, as defined in section 897(h)(4)(B).

(h) *Notice requirements applicable to corporations*—(1) *Statement to foreign interest-holder*—(i) *In general.* A domestic corporation must, within a reasonable period after receipt of a request from a foreign person holding an interest in it, inform that person whether the interest constitutes a U.S. real property interest. No particular form is required for this statement, which need only indicate the corporation's determination. The statement must be dated and signed by a responsible corporate officer who must verify under penalties of perjury that the statement is correct to his knowledge and belief.

(ii) *Required determination.* For purposes of the statement required by paragraph (h)(1)(i) of this section, an interest in a corporation is a U.S. real property interest if the corporation was a U.S. real property holding corporation on any determination date during the 5-year period ending on the date specified in the interest-holder's request, or on the date such request was received if no date is specified (or during such shorter period ending on the date that is applicable pursuant to section 897(c)(1)(A)(ii). However, an interest in a corporation is not a U.S. real property interest if such interest is excluded under section 897(c)(1)(B).

(2) *Notice to the Internal Revenue Service.* If a foreign interest holder requests that a domestic corporation provide a statement described in paragraph (h)(1) of this section, then such corporation must provide a notice to the Internal Revenue Service in accordance with this paragraph (h)(2). No particular form is required for such notice, but the following must be provided:

(i) A statement that the notice is provided pursuant to the requirements of § 1.897–2(h)(2);

(ii) The name, address, and identifying number of the corporation providing the notice;

(iii) The name, address, and identifying number (if any) of the foreign interest holder that requested the statement (this information may be omitted from the notice if fully set forth in the statement to the foreign interest holder attached to the notice).

(iv) Whether the interest in question is a U.S. real property interest;

(v) A statement signed by a responsible corporate officer verifying under penalties of perjury that the notice (including any attachments thereto) is correct to his knowledge and belief. A copy of any statement provided to the foreign interest holder must be attached to the notice. The notice must be mailed to the address specified in the Instructions for Form 8288 under the heading ''Where To File'' on or before the 30th day after the statement referred to in § 1.897–2(h)(1) is mailed to the interest holder that requested it. Failure to mail such notice within the time period set forth in the preceding sentence will cause the statement provided pursuant to § 1.897–2(h)(1) to become an invalid statement.

(3) *Requirements not applicable.* The requirements of this paragraph (h) do not apply to domestically-controlled REITS, as defined in section 897(h)(4)(B). These requirements also do not apply to a corporation any class of stock in which is regularly traded on an established securities market at any time during the calendar year. However, such a corporation may voluntarily choose to comply with the requirements of paragraph (h)(4) of this section.

(4) *Voluntary notice to Internal Revenue Service*—(i) *In general.* A domestic corporation which determines that it is not a U.S. real property holding corporation—

(A) On each of the applicable determination dates in a taxable year, or

(B) Pursuant to section 897(c)(1)(B), may attach to its income tax return for that year a statement informing the Internal Revenue Service of its determination. A corporation that has provided a voluntary notice described in this § 1.897–2(h)(4)(i) for the immediately preceding taxable year and that does not have an event described in § 1.897–2(c)(1) (ii), (iii) or (iv) prior to receiving a request from a foreign person under § 1.897–2(h)(1), is exempt from the notice requirement of § 1.897–2(h)(2).

(ii) *Early termination of real property holding corporation status.* A corporation that determines during the course of its taxable year that interests in it have ceased to be U.S. real property interests pursuant to the rules of section 897(c)(1)(B) may, on the day of its determination or thereafter, provide a statement to the address specified in the Instructions for Form 8288 under the heading ''Where To File'', informing the Service of its determination. No particular form is required but the statement must set forth the corporation's name, address, identification number, a brief statement regarding its determination and the date such determination was made. Such statement will enable foreign interest-holders to dispose of their interests without being subject to section 897(a), as provided in paragraph (g) of this section.

(5) *Supplemental statements*—(i) *By corporations with substantial intangible assets.* A corporation that is subject to the requirements of paragraph (h)(2) of this section (or that voluntarily complies with the requirements of paragraph (h)(4) of this section) must submit a supplemental statement to the Internal Revenue Service if—

(A) Such corporation values any of the intangible assets described in § 1.897–1(f)(1)(ii) (other than goodwill or going concern value) by a method other than the purchase price or book value methods described in § 1.897–1(o)(4); and

(B) The fair market value of such intangible assets equals or exceeds 25 percent of the total of the fair market values of the assets the corporation is considered to hold in accordance with the provisions of paragraphs (d) and (e) of this section.

The supplemental statement must inform the Internal Revenue Service that the corporation meets the criteria of subdivisions (A) and (B) of this paragraph (h)(5)(i), and must summarize the methods and calculations upon which the corporation's determination of the

fair market value of its intangible assets is based. In addition, the supplemental statement must list any intangible assets that were purchased from any person that have been valued by the corporation at an amount other than their purchase price, and must provide a justification for such a departure from the purchase price. The supplemental statement must be attached to or incorporated in the statement provided under paragraph (h)(2) or (h)(4) of this section.

(ii) *Corporation not valuing goodwill or going concern value at purchase price.* A corporation that is subject to the requirements of paragraph (h)(2) of this section (or that voluntarily complies with the requirements of paragraph (h)(4) of this section) must submit a supplemental statement to the Internal Revenue Service if such corporation values goodwill or going concern value pursuant to §1.897–1(o)(4)(iii). The supplemental statement must set forth that it is made pursuant to this paragraph (h)(5)(ii), and must summarize the methods and calculations upon which the corporation's determination of the fair market value of such intangible assets is based. In addition, the supplemental statement must list any such assets that were purchased from any person that have been valued by the corporation at an amount other than their purchase price, and must provide a justification for such a departure from the purchase price. The supplemental statement must be attached to or incorporated in the statement provided under paragraph (h)(2) or (h)(4) of this section.

(iii) *Corporation using alternative U.S. real property holding corporation test.* A corporation that is subject to the requirements of paragraph (h)(2) of this section (or that voluntarily complies with the requirements of paragraph (h)(4) of this section) must submit a supplemental statement to the Internal Revenue Service if—

(A) Such corporation utilizes the rule of paragraph (b)(2) of this section (regarding the book values of assets held by the corporation) to presume that it is not a U.S. real property holding corporation; and

(B) Such corporation is engaged in or is planning to engage in a trade or business of mining, farming, or forestry, or of buying and selling or developing real property, or of leasing real property to tenants.

The supplemental statement must inform the Internal Revenue Service that the corporation meets the criteria of subdivisions (A) and (B) of this paragraph (h)(5)(iii), and must be attached to or incorporated in the statement provided under paragraph (h)(2) or (h)(4) of this section.

(iv) *Corporation determining real property holding corporation status of second corporation.* A corporation that is subject to the requirements of paragraph (h)(2) of this section (or that voluntarily complies with the requirements of paragraph (h)(4) of this section) must submit a supplemental statement to the Internal Revenue Service if such corporation independently determines whether or not an interest in a second corporation is a U.S. real property interest, pursuant to paragraph (g)(2)(iv) of this section. The supplemental statement must set forth that it is made pursuant to this paragraph (h)(5)(iv) and must briefly summarize the facts upon which the corporation's determination is based and the sources of the information relied upon by the corporation. The supplemental statement must be attached to or incorporated in the statement provided under paragraph (h)(2) or (h)(4) of this section.

(i) *Transition Rules*—(1) *General waiver of penalties for failure to file.* If a foreign person disposed of an interest in a domestic corporation between June 18, 1980 and January 23, 1987, and such person establishes under the rules of paragraph (g) of this section at any time that the interest disposed of was not a U.S. real property interest, then such person shall not be subject to tax under section 897 and shall not be subject to penalties (or interest) for failure to file an income tax return with respect to such disposition.

(2) *Foreign persons that met the requirements of prior regulations.* A foreign person that disposed of an interest in a domestic corporation between June 18, 1980 and January 23, 1987, shall be deemed to have satisfied the requirements of paragraph (g) of this section with respect to such disposition if such

person established under prior temporary or prior final regulations issued under section 897 that the interest disposed of was not a U.S. real property interest.

(Sec. 897 (94 Stat. 2683; 26 U.S.C. 897), sec. 6011 (68A Stat. 732; 26 U.S.C. 6011) and sec. 7805 (68A Stat. 917; 26 U.S.C. 7805) of the Internal Revenue Code of 1954)

[T.D. 7999, 49 FR 50702, Dec. 31, 1984; 50 FR 12531, Mar. 29, 1985; T.D. 8113, 51 FR 46627, Dec. 24, 1986; 52 FR 3796, 3916, Feb. 6, 1987; T.D. 9082, 68 FR 46083, Aug. 5, 2003; T.D. 9751, Feb. 19, 2016]

§ 1.897–3 Election by foreign corporation to be treated as a domestic corporation under section 897(i).

(a) *Purpose and scope.* This section provides rules pursuant to which a foreign corporation may elect under section 897(i) to be treated as a domestic corporation for purposes of sections 897, 1445, and 6039C and the regulations thereunder. A foreign corporation with respect to which an election under section 897(i) is in effect is subject to all rules under sections 897 and 1445 that apply to domestic corporations. Thus, for example, if a foreign corporation that has made an election under section 897(i) is a U.S. real property holding corporation, interests in it are U.S. real property interests that are subject to withholding under section 1445, and any gain or loss from the disposition of such interests by a foreign person will be treated as effectively connected with a U.S. trade or business under section 897(a). Similarly, if a foreign corporation makes an election under section 897(i), its distribution of a U.S. real property interest pursuant to section 301 will be subject to the carryover basis rule of section 897(f). However, an interest in an electing corporation is not a U.S. real property interest if following the election the interest is described in section 897(c)(1)(B) or § 1.897–1(c)(2) (subject to the exceptions of subdivisions (i) and (ii) of that section). In addition, section 897(d) will not apply to any distribution of a U.S. real property interest by such corporation or to any sale or exchange of such interest pursuant to a plan of complete liquidation under section 337. A foreign corporation that makes an election under section 897(i) shall not be treated as a domestic corporation for purposes of any other provision of the Code or regulations, except to the extent that it is required to consent to such treatment as a condition to making the election. For further information concerning the effect of an election under section 897(i) upon the withholding requirements of section 1445, see § 1.1445–7. An election under section 897(i) is the exclusive remedy of any foreign person claiming discriminatory treatment under any treaty with respect to the application of sections 897, 1445, and 6039C to a foreign corporation. Therefore, if a corporation does not make an effective election, relief under a nondiscrimination article of any treaty shall not be otherwise available with respect to the application of sections 897, 1445, and 6039C to such corporation.

(b) *General conditions.* A foreign corporation may make an election under section 897(i) only if it meets all three of the following conditions.

(1) *Holding a U.S. real property interest.* The foreign corporation must hold a U.S. real property interest at the time of the election. This condition is satisfied when a U.S. real property interest is acquired simultaneously with the effective date of an election. For example, this condition is satisfied when real property is acquired in an exchange described in section 351 that is carried out simultaneously with the effective date of the election. This condition is also satisfied by a corporation that indirectly holds a U.S. real property interest through a partnership, trust, or estate.

(2) *Entitlement to nondiscriminatory treatment.* The foreign corporation must be entitled to nondiscriminatory treatment with respect to its U.S. real property interest under any treaty to which the United States is a party. Where the corporation indirectly holds a U.S. real property interest through a partnership, trust, or estate, the corporation itself must be entitled to nondiscriminatory treatment with respect to such property interest.

(3) *Submission of election in proper form.* The foreign corporation must comply with the requirements of paragraph (c) of this section respecting the manner and form in which an election must be submitted.

(c) *Manner and form of election.* An election under section 897(i) is made by filing the materials described in subparagraphs (1) through (5) of this paragraph (c) at the address specified in the Instructions for Form 8288 under the heading ''Where To File''. The required items may be incorporated in a single document.

(1) *General statement.* The foreign corporation must supply a general statement indicating that an election under section 897(i) is being made. The general statement must be signed by a responsible corporate officer, who must verify under penalty of perjury that the statement and all other documents submitted pursuant to the requirements of this paragraph (c) are true and correct to his knowledge and belief. No particular form is required for the statement, which must contain all the following information—

(i) The name, address, identifying number, and place and date of incorporation of the foreign corporation;

(ii) The treaty and article under which the foreign corporation is seeking nondiscriminatory treatment;

(iii) A description of the U.S. real property interests held by the corporation, either directly or through a partnership, trust, or estate, including the dates such interests were acquired, the corporation's adjusted bases in such interests, and their fair market values as of the date of the election (or book values if the corporation is not a U.S. real property holding corporation under the alternative test of § 1.897–2(b)(2)); and

(iv) A list of all dispositions of any interests in the foreign corporation after December 31, 1979, and before June 19, 1980, between related persons (as defined in section 453(f)(1)), giving the type and the amount of any interest transferred, the name and address of the related person to whom the interest was transferred, the transferor's basis in the interest transferred, and the amount of any nontaxed gain as defined in section 1125(d) of Pub. L. 96–499.

(2) *Waiver of treaty benefits.* The foreign corporation must submit a binding waiver of the benefits of any U.S. treaty with respect to any gain or loss from the disposition of a U.S. real property interest during the period in which the election is in effect.

(3) *Consent to be taxed.* The foreign corporation must submit a binding agreement to treat as though it were a domestic corporation any gain or loss that is recognized upon—

(i) The disposition of any U.S. real property interest during the period in which the election is in effect, and

(ii) The disposition of any property that it acquired in exchange for a U.S. real property interest in a nonrecognition transaction (as defined under section 897(e)) during the period in which the election is in effect.

(4) *Interest-holders' consent to election*—(i) *In general.* The foreign corporation must submit both a signed consent to the making of the election and a waiver of U.S. treaty benefits with respect to any gain or loss from the disposition of an interest in the corporation from each person who holds an interest in the corporation on the date the election is made. In the case of a corporation any class of stock of which is regularly traded on an established securities market at any time during the calendar year, the signed consent and waiver need only be provided by a person who holds an interest described in § 1.897–1(c)(2)(iii)(A) or (B) (determined after application of the constructive ownership rules of section 897(c)(6)(C). The foreign corporation must also include with the signed consents and waivers a list that identifies and describes the interest in the corporation held by each interest holder, including the type and amount of such interest and its fair market value as of the date of the election.

(ii) *Corporation's retention of interest-holders' consents.* A corporation need not file the consents and waivers of its interest-holders as required by paragraph (c)(4)(i) of this section, if it instead complies with the requirements of subdivisions (A) through (D) of this paragraph (c)(4)(ii).

(A) The corporation must place a legend on each outstanding certificate for shares of its stock that reads substantially as follows: ''(Name of corporation) has made an election under section 897(i) of the United States Internal Revenue Code to be treated as a U.S. corporation for certain tax purposes,

and any purchaser of this interest may therefore be required to withhold tax at the time of the purchase.'' The corporation must certify that the foregoing requirement has been met and that it will place an equivalent legend on every stock certificate that is issued while the election under section 897(i) is in effect and the corporation retains the consents and waivers of its interest-holders under the rules of this paragraph (c)(4)(ii). However, with respect to any registered certificate issued prior to January 30, 1985, in lieu of placing a legend on the certificate the corporation may certify that it will provide the purchaser of the interest with a copy of the legend at the time the certificate is surrendered for issuance of a new certificate.

(B) The corporation must include with its election a statement that the corporation has received both a signed consent to the making of the election and a waiver of U.S. treaty benefits with respect to any gain or loss from the disposition of an interest in the corporation from each person who holds an interest in the corporation on the date the election is made. In the case of a corporation any class of stock of which is regularly traded on an established securities market at any time during the calendar year, the signed consent and waiver need only be provided by a person who holds or has held an interest described in §1.897–1(c)(2)(iii) (A) or (B) (determined after application of the constructive ownership rules of section 897(c)(6)(C).

(C) The corporation must include with its election a list that describes the interests in the corporation held by each interest-holder. The list need not identify the interest-holders by name, but must set forth the type, amount, and fair market value of the interests held by each.

(D) The corporation must include with its election an agreement that the corporation will retain all signed consents and waivers for a period of three years from the date of the election and supply such documents to the Director within 30 days of his request for production thereof. The Director's review of the signed consents and waivers pursuant to this provision shall not constitute an examination for purposes of section 7605(b).

(5) *Statement regarding prior dispositions.* The foreign corporation must state that no interest in the corporation was disposed of during the shortest of (A) the period from June 19, 1980, through the date of the election, (B) the period from the date on which the corporation first holds a U.S. real property interest through the date of the election or (C) the five-year period ending on the date of the election. If the corporation cannot state that no such dispositions have been made, it may make the section 897(i) election only if it states that it has complied with the requirements of paragraph (d)(2) of this section.

(d) *Time and duration of election*—(1) *In general.* A foreign corporation that meets the conditions of paragraph (b) of this section may make an election under section 897(i) at any time before the first disposition of an interest in the corporation which would be subject to section 897(a) if the election had been made before that disposition, except as otherwise provided in paragraph (d)(2) of this section. The period to which the election applies begins on the date on which the election is made, or such earlier date as is specified in the election, but not earlier than June 19, 1980. Unless revoked, an election applies for the duration of the time for which the corporation remains in existence. An election is made on the date that the statements described in paragraph (c) of this section are delivered to the address specified in the Instructions for Form 8288 under the heading ''Where To File''. If the election is delivered by United States mail, the provisions of section 7502 and the regulations thereunder shall apply in determining the date of delivery.

(2) *Election after disposition of stock.* An election under section 897(i) may be made after any disposition of an interest in the corporation which would have been subject to section 897(a) if the election had been made before that disposition, but only if the requirements of either subdivision (i) or (ii) of this paragraph (d)(2) are met with respect to all dispositions of interests during the period described in paragraph (c)(5) of this section.

(i) There is a payment of an amount equal to any taxes which would have been imposed by reason of the application of section 897 upon all persons who had disposed of interests in the corporation during the period described in paragraph (c)(5) of this section had the corporation made the election prior to such dispositions. Such payment must be made by the later of the date the election is made, or the date on which payment of such taxes would otherwise have been due, and must include any interest that would have accrued had tax actually been due with respect to the disposition. As an election made prior to any disposition of interests in the corporation would have been conditioned on a waiver of treaty benefits by the interest-holders, payment of an amount equal to tax and any interest with respect to such prior disposition is required as a condition to making a subsequent election under this subdivision (i) irrespective of the application of any treaty provision. For this purpose, it is not necessary that the payment be made by the person who would have owed the tax if the election under this section had been made prior to the disposition, and that person is under no obligation to supply any information to the present holders of interests in the electing corporation. The payment shall be made to the U.S. Treasury. Where the payment is made by a present holder of an interest, the basis of the person's interest in the corporation shall be increased to the extent of the amount paid.

(ii) Each person that acquired an interest in the electing corporation took a basis in the interest that was equal to the basis of the interest in the hands of the person from which the interest was acquired, increased by the sum of any gain recognized by the transferor of the interest and any tax paid under chapter 1 by the person that acquired the interest, if such interest was acquired after June 18, 1980.

(3) *Adequate proof of basis.* For purposes of meeting the conditions of paragraph (d)(2) (i) or (ii) of this section, a corporation must establish the bases of and amount of gain realized by all persons who disposed of interests in the corporation during the period described in paragraph (c)(5) of this section. See paragraph (g)(3) of this section for an exception to this rule.

(4) *Acknowledgement of receipt.* Within 60 days after its receipt of an election udner section 897(i), the Internal Revenue Service will acknowledge receipt of the election. Such acknowledgement either will indicate that the information submitted with the election is complete or will specify any documents that remain to be submitted pursuant to the requirements of paragraph (c) of this section respecting the manner and form in which an election must be made.

(e) *Anti-abuse rule*—(1) *In general.* A corporation that is otherwise eligible to make an election under section 897(i) may do so only by complying with the requirements of subdivision (2) of this paragraph, if during the period described in paragraph (c)(5) of this section—

(i) Prior to receipt of a U.S. real property interest by the corporation seeking to make the election, stock in such corporation (or in any corporation controlled by such corporation) was acquired in a transaction in which the person acquiring such stock obtained an increase in basis in the stock over the adjusted basis of the stock in the hands of the person from whom it was acquired;

(ii) The full amount of gain realized by the person from whom the stock was acquired was not subject to U.S. tax; and

(iii) The corporation seeking to make the election received the U.S. real property interest in a transaction or series of transactions to which section 897 (d)(1)(B) or (e)(1) applies to allow for nonrecognition of gain.

(2) *Recognition of gain.* A corporation described in subparagraph (1) of this paragraph (e) may make an election under section 897(i) only if it pays an amount equal to the tax on the full amount of gain realized by the transferors of the stock of such corporation (or of any corporation controlled by it) in the transaction described in paragraph (e)(1)(i) of this section. However, such amount must be paid only if the stock of the corporation seeking to make the election (or the stock of a corporation controlled by it) would have constituted a U.S. real property

interest had it (or a corporation controlled by it) made the election before that acquisition. Such amount must be paid by the later of the date of the election or the date on which such tax would otherwise be due, and must include any interest that would have accrued had tax actually been due with respect to the disposition.

(3) *Definition of control.* For purposes of this paragraph, a corporation controls a second corporation if it holds 80 percent or more of the total combined voting power of all classes of stock entitled to vote, and 80 percent or more of the total number of shares of all other classes of stock of the second corporation. In a chain of corporations where each succeeding corporation is controlled within the meaning of this subparagraph (3) by the corporation immediately above it in the chain, each corporation in the chain shall be considered to be controlled by all corporations that preceded it in the chain.

(4) *Examples.* The rules of this paragraph (e) are illustrated by the following examples.

Example 1. Nonresident alien individual X owns 100 percent of the stock of foreign corporation L which was organized in 1981. L's only asset is a parcel of U.S. real property which it has held since 1981. The fair market value of the U.S. real property held by L on January 1, 1984, is $1,000,000. L's basis in the property is $200,000. X's basis in the L stock is $500,000. On June 1, 1984, M corporation, a foreign corporation owned by foreign persons who are unrelated to X, purchases the stock of L from X for $1,000,000 with title passing outside of the United States. Since the stock of L is not a U.S. real property interest, X's gain from the disposition of the L stock ($500,000) is not treated as effectively connected with a U.S. trade or business under section 897(a). In addition, since X was neither engaged in a U.S. trade or business nor present in the U.S. at any time during 1984, such gain is not subject to U.S. tax under section 871. On January 1, 1987, M liquidates L under a plan of liquidation adopted on that same date. Under section 332 of the Code M recognizes no gain on receipt of the parcel of U.S. real property distributed by L in liquidation. Under section 334(b)(1) M takes $200,000 as its basis in the U.S. real property received from L. Under section 897(d)(1)(B) no gain would be recognized to L under section 897(d)(1)(A) on the liquidating distribution. As a consequence, no gain is recognized to L under section 336 of the Code. After its receipt of the U.S. real property from L, M seeks to make an election to be treated as a domestic corporation. Thus, M acquired the L stock in a transaction in which it obtained a basis in such stock in excess of the adjusted basis of X in the stock, U.S. tax was not paid on the full amount of the gain realized by X, and M has received the property in a distribution to which section 897(d)(1)(B) applied to provide for nonrecognition of gain to L. Therefore, M may make the election only if it pays an amount equal to the tax on the full amount of X's gain, pursuant to the rule of subparagraph (e)(2) of this section.

Example 2. Nonresident alien individual X owns 100 percent of the stock of foreign corporation A which owns 100 percent of the stock of foreign corporation B. X's basis in the A stock is $500,000. A's basis in the B stock is $500,000. B owns U.S. real property with a fair market value of $1,000,000. B's basis in the U.S. real property is $500,000. On January 1, 1985, X sells the stock of A to Y, an unrelated individual, for $1,000,000 with title passing outside of the United States. In addition, X was neither engaged in a U.S. trade or business nor present in the U.S. at any time during 1985. Since the A stock is not a U.S. real property interest, X's gain on such disposition is not treated as effectively connected with a U.S. trade or business under section 897(a) and is therefore not subject to U.S. tax under section 871. On July 1, 1987, a plan of liquidation is adopted, and B is liquidated into A. Under sections 332, 334(b)(1), 336, and 897(d)(1)(B), there is no tax to A on receipt of U.S. real property from B and no tax to B on the distribution of the U.S. real property interest to A. After receipt of the property A seeks to make an election under section 897(i). Under the rules of paragraph (e) of this section, A may make the election only if it pays an amount equal to the tax on the full amount of X's gain. (Assuming that A is a U.S. real property holding corporation, the same result would be required by the rule of paragraph (d)(2) of this section.)

(f) *Revocation of election*—(1) *In general.* An election under section 897(i) may be revoked only with the consent of the Commissioner. A request for revocation shall be in writing and shall be delivered to the address specified in the Instructions for Form 8288 under the heading ''Where To File''. The request shall include the name, address, and identifying number of the corporation seeking to revoke the election, and a description of all U.S. real property interests held by the corporation on the date of the request for revocation, including the dates such interests were acquired, the corporation's adjusted bases in such interests, and their fair

market values as of the date of the request (or book value if the corporation is not a U.S. real property holding corporation under the alternative test of § 1.897–2(b)(2)). The request shall be signed by a responsible officer of the corporation under penalty of perjury and shall contain a statement either that the corporation has made no distributions described in subparagraph (2) of this paragraph (f) or that the conditions of that subparagraph have been satisifed. A revocation will be effective as of the date the request is delivered to the address specified in the Instructions for Form 8288 under the heading ''Where To File'', unless the Commissioner provides otherwise in his consent to the revocation. If the request is delivered by United States mail, the provisions of section 7502 and the regulations thereunder shall apply in determining the date of delivery. The Commissioner will generally consent to a revocation, provided either that there have been no distributions described in subparagraph (2) of this paragraph (f), or that the conditions of that subparagraph have been satisfied. Within 90 days after its receipt of a request to revoke an election under section 897(i), the Internal Revenue Service will acknowledge receipt of the request. Such acknowledgement either will indicate that the information submitted with the request is complete or will specify any information that remains to be submtted pursuant to the requirements of this paragraph (f).

(2) *Revocation after distribution.* If there have been any distributions of U.S. real property interests by the corporation during the period to which an election made under section 897(i) applies, the Commissioner shall consent to the revocation of such election only if one of the following conditions is met.

(i) The full amount of gain realized by the corporation upon the distribution was subject to U.S. income tax.

(ii) There is a payment of an amount equal to the taxes that would have been imposed upon the corporation by reason of the application of section 897 if the election had not been in effect on the date of the distribution. Such payment must be made by the later of the date of the request for revocation or the date on which payment of such tax would otherwise have been due, and must include any interest that would have accrued had tax actually been due with respect to the distribution. If under the terms of any treaty to which the United States is a party such distribution would not have been subject to U.S. income tax notwithstanding the provisions of section 897, then this condition may be satisfied by providing a statement with the request for revocation setting forth the treaty and article which would have exempted the distribution from U.S. tax had the election under section 897(i) not been in effect on the date thereof.

(iii) At the time of the receipt of the distributed property, the distributee would be subject to taxation under chapter 1 of the Code on a subsequent disposition of the distributed property, and the basis of the distributed property in the hands of the distributee is no greater than the adjusted basis of such property before the distribution, increased by the amount of gain (if any) recognized by the distributing corporation. For purposes of this paragraph (f)(2)(i)(C), a distributee shall be considered to be subject to taxation upon a subsequent disposition of distributed property only if such distributee waives the benefits of any U.S. treaty that would otherwise render such disposition not taxable by the United States. Such waiver must be attached to the corporation's request for revocation.

(g) *Transitional rules*—(1) *In general.* An election under section 897(i) that was made at any time after June 18, 1980, must be amended to comply with the requirements of paragraphs (b), (c), and (d) of this section. Such amendment must be delivered in writing to the Director, Philadelphia Service Center by April 1, 1985. If the amendment is delivered by United States mail, the provisions of section 7502 and the regulations thereunder shall apply in determining the date of delivery. An election that is properly amended pursuant to the requirements of this section shall be effective as of the date of the original election.

(2) *Corporations previously entitled to make election.* A foreign corporation that would have been entitled under

the rules of this section to make a section 897(i) election at any time between June 19, 1980, and January 30, 1985, may retroactively make such an election pursuant to the requirements of this section. Such election must be delivered to the Director, Foreign Operations District, by March 1, 1985.

(3) *Interests in corporation disposed of prior to publication*. Where interests in a corporation were disposed of before January 3, 1984, the requirement of paragraph (d)(2) of this section may be met, notwithstanding the requirement of paragraph (d)(3), by paying a tax that is based upon a reasonable estimate of the gain upon the prior dispositions. Such estimate must be based on all facts and circumstances known to, and ascertainable through the exercise of reasonable diligence by, the corporation seeking to make the election.

(h) *Effective date*. The requirement in paragraph (c)(1)(i) of this section that the statement making the section 897(i) election contain the identifying number of the foreign corporation (in all cases) is applicable November 3, 2003.

(Sec. 897 (94 Stat. 2683; 26 U.S.C. 897), sec. 6011 (68A Stat. 732; 26 U.S.C. 6011) and sec. 7805 (68A Stat. 917; 26 U.S.C. 7805) of the Internal Revenue Code of 1954)

[T.D. 7999, 49 FR 50713, Dec. 31, 1984; 50 FR 12531, Mar. 29, 1985; T.D. 8113, 51 FR 46629, Dec. 24, 1986; T.D. 9082, 68 FR 46083, Aug. 5, 2003; T.D. 9751, 81 FR 8400, Feb. 19, 2016]

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[T.D. 8198, 53 FR 16217, May 5, 1988]

§ 1.897–5 Corporate distributions.

(a) through (d)(1)(iii)(E) [Reserved]. For further guidance, see § 1.897–5T(a) through (d)(1)(iii)(E).

(d)(1)(iii)(F) Identification by name and address of the distributee or transferee, including the distributee's or transferee's taxpayer identification number;

(d)(1)(iii)(G) through (d)(4) [Reserved]. For further guidance, see § 1.897–5T(d)(1)(iii)(G) through (d)(4).

(e) *Effective date.* This section is applicable to transfers and distributions after November 3, 2003.

[T.D. 9082, 68 FR 46083, Aug. 5, 2003]

§ 1.897–5T Corporate distributions (temporary).

(a) *Purpose and scope.* This section provides rules concerning the recognition of gain or loss and adjustments to basis required with respect to certain corporate distributions that are subject to section 897. Paragraph (b) of this section provides rules concerning such distributions by domestic corporations, including distributions under section 301, distributions in redemption of stock, and distributions in liquidation. Paragraph (c) sets forth rules concerning distributions by foreign corporations, including distributions under sections 301 and 355, distributions in redemption of stock, and distributions in liquidation. Finally, various rules generally applicable to distributions subject to this section, as well as to transfers subject to § 1.897–6T, are set forth in paragraph (d). The rules contained in this section are also subject to the tax avoidance rules of § 1.897–6T(c).

(b) *Distributions by domestic corporations*—(1) *Limitation of basis upon dividend distribution of U.S. real property interest.* Under section 897(f), if any domestic corporation (distributing corporation) distributes a U.S. real property interest to a shareholder that is a foreign person (distributee) in a distribution to which section 301 applies, then the basis of the distributed U.S. real property interest in the hands of the foreign distributee shall be determined in accordance with the provisions of section 301(d), and shall not exceed—

(i) The adjusted basis of the property before the distribution in the hands of the distributing corporation, increased by

(ii) The sum of—

(A) Any gain recognized by the distributing corporation on the distribution, and

(B) Any U.S. tax paid by or on behalf of the distributee with respect to the distribution.

(2) *Distributions by U.S. real property holding corporations which are taxable exchanges of stock under generally applicable rules.* If a domestic corporation, stock in which is treated as a U.S. real property interest, distributes property with respect to such stock to a foreign shareholder, the distributee shall be treated as having disposed of a U.S. real property interest, and shall recognize gain or loss on the stock of such domestic corporation to the extent that, with respect to the distributees—

(i) Part of all of the distribution is treated pursuant to section 301(c)(3)(A) as a sale or exchange of stock;

(ii) Part or all of the distribution is treated pursuant to section 302(a) as made in part or full payment in exchange for stock; or

(iii) Part or all of the distribution is treated pursuant to section 331(a) as made in full payment in exchange for stock.

Stock in a domestic corporation shall not be considered a U.S. real property interest pursuant to the provisions of § 1.897–2(f)(2) if the corporation does not hold any U.S. real property interests and has disposed of all of its U.S. real property interests owned within the previous five years in transactions in which the full amount of gain was recognized under the rules of § 1.897–2(f)(2). If gain is recognized at the corporate level on either a distribution of a U.S. real property interest or a sale of a U.S. real property interest in a liquidation, such distribution or sale shall be considered a disposition for purposes of § 1.897–2(f)(2). With regard to the consequences of a distribution from a U.S. real property holding corporation under section 355(a), see § 1.897–6T(a) (1) and (4).

(3) *Section 332 liquidations of U.S. real property holding corporations*—(i) *General rules.* Exchanges that are subject to section 897(e) are normally covered by § 1.897–6T(a) (1), (2) and (3). This paragraph (b)(3) provides rules concerning the application of section 897(e) and the general principles of § 1.897–6T(a) (1), (2) and (3) to section 332 liquidations of U.S real property holding corporations.

(ii) *Distribution to a foreign corporation under section 332 after June 18, 1980, and before the repeal of the General Utilities doctrine.* Except for distributions under paragraph (b)(3)(iii) of this section (relating to section 332 and former section 334(b)(2)), the rules of this paragraph (b)(3)(ii) shall apply to section 332 distributions after June 18, 1980, and before January 1, 1990, pursuant to section 336(a) as in effect prior to the effective dates of the amendments made by section 631 of the Tax Reform Act of 1986. A foreign corporation that meets the stock ownership requirements of section 332(b) with respect to stock in a domestic corporation that is a U.S. real property interest shall not, after December 31, 1984, be subject to taxation by reason of section 367(a). The foreign corporation shall recognize gain pursuant to section 897(e)(1) on such stock upon the receipt of property in a section 332(a) liquidation from such domestic corporation, but only to the extent that the property received constitutes property other than a U.S. real property interest. The gain on the stock in the domestic corporation to be recognized by the foreign corporation pursuant to section 897(e)(1) shall be determined by multiplying the gain realized on the distribution by a fraction. The numerator of the fraction shall be the fair market value of the property other than U.S. real property interests received by the foreign corporation on the distribution, and the denominator shall be the fair market value of all property received by the foreign corporation on the distribution. The bases of the distributed U.S. real property interests in the hands of the foreign corporation shall be the same as the bases in the hands of the domestic corporation. The bases of the property other than U.S. real property interests in the hands of the foreign corporation shall be the same as the bases in the hands of the domestic corporation, plus any gain recognized by the foreign corporation on the distribution allocated among such assets in proportion to the potential gain inherent in each such asset at the time of distribution. However, the basis of each asset is limited to its fair market value. Property, other than a U.S. real property interest

that is distributed by the domestic corporation, shall not be considered to be distributed by the domestic corporation pursuant to a section 332 liquidation (that is, the foreign corporation shall not be considered to be a corporation for purposes of section 332) if the requirements of section 367(a) are not satisfied. *See*, for example, sections 1245(b)(3) and 1250(d)(3) regarding the consequences to the distributing domestic corporation if the requirements of section 367(a) are not satisfied.

(iii) *Distribution to a foreign corporation under section 332 and former section 334(b)(2) after June 18, 1980.* The rules of this paragraph (b)(2)(iii) shall apply to section 332 distributions after June 18, 1980 where the basis of the distributed property in the hands of the foreign corporation is determined under section 334(b)(2) as in effect prior to the Tax Equity and Fiscal Responsibility Act of 1982. A foreign corporation that meets the stock ownership requirements of section 332(b) with respect to stock in a domestic corporation that is a U.S. real property interest shall recognize gain on the receipt of property in a section 332(a) liquidation where section 334(b)(2) applies to the extent that the fair market value of the distributed assets that are not U.S real property interests exceeds the basis of such assets determined under section 334(b)(2) (for example, if the liquidation does not occur immediately upon the purchase of stock in the domestic corporation). The gain recognized shall not exceed the excess of the fair market value of the stock of the domestic corporation in the hands of the foreign corporation at the time of the distribution over the shareholder's adjusted basis in such stock. The basis of the distributed U.S. real property interests in the hands of the foreign corporation shall be determined under section 334(b)(2), by reference to the adjusted basis of the stock with respect to which the distribution was made. The basis of such property other than U.S. real property interests shall be tentatively determined under section 334(b)(2), and then increased by any gain recognized by the foreign corporation on the distribution allocated among such assets in proportion to the potential gain inherent in each such asset at the time of distribution (computed using the tentative basis as determined under section 334(b)(2)). The basis of each asset is limited, however, to its fair market value.

(iv) *Distribution to a foreign corporation under section 332 after July 31, 1986 and after the repeal of the General Utilities doctrine.* The rules of this subdivision (iv) shall apply to section 332 distributions after July 31, 1986, pursuant to section 337(a) as in effect after the effectivie dates of the amendments of section 631 of the Tax Reform Act of 1986.

(A) *Liquidation of domestic corporation.* A foreign corporation that meets the stock ownership requirements of section 332(b) with respect to stock in a domestic corporation that is a U.S. real property interest (except a foreign corporation that has made an effective election under section 897(i) and the stock of which is treated as a U.S. real property interest) shall not recognize any gain under sections 367(a) or 897(e)(1) on the receipt of property in a section 332(a) liquidation. The domestic corporation shall not recognize gain under section 367(e)(2) on the distribution of U.S. real property interests (other than stock in a former U.S. real property holding corporation which is treated as a U.S. real property interest) to the foreign corporation. The domestic corporation shall recognize gain under section 367(e)(2) on the distribution of stock in a former U.S. real property holding corporation which is treated as a U.S. real property interest. With respect to the recognition of gain or loss by the domestic corporation under section 367(e)(2) on the distribution of property other than U.S. real property interests, see the regulations under section 367(e)(2). The basis of the distributed U.S. real property interests (other than stock in a former U.S. real property holding corporation) in the hands of the foreign corporation shall be the same as it was in the hands of the domestic corporation. The basis of any property (other than U.S. real property interests) and stock in a former U.S. real property holding corporation that is a U.S. real property interest in the hands of the foreign corporation shall be the same as it was in the hands of the domestic corporation

increased by any gain recognized by the distributing corporation on the distribution that was subject to U.S. taxation.

(B) *Liquidation of certain foreign corporations making a section 897(i) election.* A foreign corporation that meets the stock ownership requirements of section 332(b) with respect to stock in another foreign corporation, that has made an effective election under section 897(i) and the stock of which is treated as a U.S. real property interest, shall recognize gain pursuant to section 897(e)(1) on such stock upon the receipt from the distributing foreign corporation of property that is not a U.S. real property interest, and that is not used by the distributee foreign corporation in the conduct of a trade or business within the United States (if the distributee foreign corporation is not a resident of a country with which the United States maintains an income tax treaty) or in a permanent establishment within the United States (if the distributee foreign corporation is a resident of a country with which the United States maintains an income tax treaty). The gain on the stock in the foreign corporation (making an effective election under section 897(i)) to be recognized by the distributee foreign corporation pursuant to section 897(e)(1) shall be determined by multiplying the gain realized on the distribution by a fraction. The numerator of the fraction shall be the fair market value of the property received by the distributee foreign corporation upon which it must recognize gain, and the denominator of the fraction shall be the fair market value of all property received by the distributee foreign corporation on the distribution. The distributing foreign corporation shall not recognize gain under section 367(e)(2) on the distribution of U.S. real property interests to the distributee foreign corporation. With respect to the recognition of gain or loss under section 367(e)(2) on the distribution of property other than U.S. real property interests, see the regulations under section 367(e)(2). The basis of the distributed U.S. real property interests in the hands of the distributee foreign corporation shall be the same as it was in the hands of the distributing foreign corporation. The basis of the property upon which the distributee foreign corporation recognized gain in the hands of the distributee foreign corporation shall be the same as the basis in the hands of the distributing foreign corporation, plus any gain recognized by the distributee foreign corporation on the receipt of such property allocated among such property in proportion to the potential gain inherent in each such property at the time of the distribution. In regard to the basis of any other property received by the distributee foreign corporation in the liquidation, see the regulations under section 367(e)(2). However, the basis of each asset is limited to its fair market value.

(v) *Transfer of foreign corporation stock followed by a section 332 liquidation treated as a reorganization.* If a nonresident alien or foreign corporation transfers the stock of a foreign-corporation that owns a U.S. real property interest to a domestic corporation in exchange for stock of the domestic corporation (or its domestic or foreign parent corporation) in a reorganization under section 368(a)(1)(B) or in an exchange under section 351(a), and if the foreign corporation then distributes the U.S. real property interest to the domestic corporation in a liquidation described in section 332(a) within five years of the transfer of the stock of the foreign corporation to the domestic corporation, then the transfer of the foreign corporation stock and the liquidation shall be treated as a reorganization described in section 368(a)(1) (C) or (D). The rules of §1.897–6T(a)(1) shall apply to the transfer of the U.S. real property interest to the domestic corporation in exchange for domestic corporation stock, and the rules of §1.897–5T(c)(4) shall apply to the distribution of domestic corporation stock by the foreign corporation. However, the rules of this paragraph (b)(3)(v) shall not apply if the transfer of the foreign corporation stock and the liquidation under section 332(a) are separate and independent transactions justified by substantial and verifiable business purposes.

(4) *Section 897(i) companies.* Except as otherwise provided herein for purposes of this section and §1.897–6T, a foreign

corporation that has made a valid election under section 897(i) shall be treated as a domestic corporation and not as a foreign corporation in determining the application of section 897. For rules concerning the making of a section 897(i) election, see §§ 1.897–3 and 1.897–8T. In regard to section 367(e)(2) and foreign corporations that have made an effective election under section 897(i), see paragraph (b)(3)(iv) of this section.

(5) *Examples*. The following examples illustrate the rules of this paragraph (b). In each example there is no applicable income tax treaty to which the United States is a party.

Example 1. (i) A is a nonresident alien who owns 100 percent of the stock of DC, a U.S. real property holding corporation. DC's only asset is Parcel P, a U.S. real property interest, with a fair market value of $500,000 and an adjusted basis of $300,000. DC completely liquidates in 1987 and distributes Parcel P to A in exchange for the DC stock held by A.

(ii) Under section 336(a), DC must recognize gain to the extent of the excess of the fair market value ($500,000) over the adjusted basis ($300,000), or $200,000.

(iii) A does not recognize any gain under section 897(a) because the DC stock in the hands of A is no longer a U.S. real property interest under paragraph (b)(2) of this section and paragraph 2(f) of § 1.897–2. A does recognize gain (if any) under section 331(a); however, the gain is not subject to taxation under section 871(a). A's adjusted basis in Parcel P is $500,000.

(iv) If DC did not recognize all of the gain on the disposition under a transitional rule to section 631 of the Tax Reform Act of 1986, then paragraph (b)(2) of this section and paragraph 2(f) of § 1.897–2 would not apply to A. A would recognize gain (if any) under paragraph (b)(2) because the distribution is treated as in full payment in exchange for the DC stock under section 897(a).

Example 2. (i) FC, a Country F corporation, owns 100 percent of the stock of DC, a U.S. real property holding corporation. FC's basis in the stock of DC is $400,000, and the fair market value of the DC stock is $800,000. DC owns a U.S. real property interest with an adjusted basis of $350,000 and a fair market value of $600,000. DC also owns other assets that are not U.S. real property interests that have an adjusted basis of $125,000 and a fair market value of $200,000. DC completely liquidates in 1985 and distributes all of its property to FC in exchange for the DC stock held by FC.

(ii) Under paragraph (b)(3)(ii) of this section, FC recognizes $100,000 of gain under section 897(a) on the disposition of the DC stock. This is determined by multiplying FC's gain realized ($400,000) by a fraction. The numerator of the fraction is the fair market value of the property other than U.S. real property interests ($200,000), and the denominator of the fraction is the fair market value of all property received ($800,000). FC takes a carryover adjusted basis in the U.S. real property interest ($350,000). FC's adjusted basis in the assets that are not U.S. real property interests ($200,000) is the basis of those assets in the hands of DC ($125,000) plus the gain recognized by FC on the distribution ($100,000) not to exceed the fair market value ($200,000).

Example 3. (i) FC, a Country F corporation, owns 100 percent of the stock of DC, a U.S. real property holding corporation. FC's basis in the stock of DC is $300,000, and the fair market value of the DC stock is $500,000. DC owns Parcel P, a U.S. real property interest, with an adjusted basis of $250,000 and a fair market value of $400,000. DC also owns all of the stock of DX, a former U.S. real property holding corporation whose stock is a U.S. real property interest, with an adjusted basis of $50,000 and a fair market value of $100,000. DC completely liquidates in 1987 and distributes all of its property to FC in exchange for the DC stock held by FC.

(ii) Under paragraph (b)(3)(iv)(A) of this section, DC recognizes $50,000 of gain on the distribution to FC of the DX stock. DC does not recognize any gain for purposes of section 367(e)(2) on the distribution to FC of Parcel P.

(iii) Under paragraph (b)(3)(iv)(A) of this section, FC's disposition of its DC stock is not treated as a disposition of a U.S. real property interest. Under section 334(b)(1), FC takes a carryover adjusted basis of $250,000 in Parcel P. FC takes an increased basis of $100,000 in the DX stock which is equal to DC's basis ($50,000) increased by the gain recognized by DC ($50,000).

(iv) The result would be the same if FC had made an effective election under section 897(i).

(6) *Section 333 elections*—(i) *General rule*. A foreign shareholder that elects section 333 as in effect prior to its repeal by the Tax Reform Act of 1986 upon the distribution of property in a liquidation by a domestic corporation whose stock is treated as a U.S. real property interest shall recognize gain on such stock to the extent that—

(A) The property received by the foreign shareholder constitutes property other than U.S. real property interests subject to U.S. taxation upon its disposition as specified by paragraph (a)(1) of this section, or

(B) The basis of a U.S. real property interest subject to U.S. taxation upon

its disposition in the hands of the recipient foreign shareholder exceeds the basis of the U.S. real property interest in the hands of the liquidating domestic corporation.

In determining the amount of gain recognized by the foreign shareholder, the foreign shareholder shall be considered to have exchanged the domestic corporation stock for all the property distributed on a proportionate fair market value basis. The gain recognized on a respective portion of domestic corporation stock shall not exceed the gain realized on that portion. Property other than U.S. real property interests subject to U.S. taxation upon disposition shall have a fair market value basis in the hands of the foreign shareholder. The basis of U.S. real property interests subject to U.S. taxation upon disposition shall be the basis of the proportionate part of the domestic corporation stock cancelled or redeemed in the liquidation, increased in the amount of gain recognized (other than gain recognized under this section) by the shareholder in respect to that proportionate part of the domestic corporation stock.

(ii) *Example*. The rules of paragraph (b)(6)(i) of this section may be illustrated by the following example.

Example. (i) A is a citizen and resident of Country F with which the U.S. does not have an income tax treaty. A owns all of the stock of DC, a U.S. real property holding corporation. The DC stock has a fair market value of $1,000,000. A acquired the DC stock in two purchases. The basis of one lot of the DC stock is $150,000, and the basis of the other lot is $650,000.

(ii) DC owns Parcel P, a U.S. real property interest, with a fair market value of $750,000 and an adjusted basis of $400,000. DC's only other property is equipment with a fair market value of $250,000 and an adjusted basis of $100,000. DC does not have any earnings and profits.

(iii) DC completely liquidates in 1985 in accordance with section 333 by distributing Parcel P and the equipment to A. A elects section 333 treatment.

(iv) A is considered as having exchanged 75 percent (fair market value of Parcel P/fair market value of all property distributed) of the DC stock for Parcel P. A realized gain of $150,000 on that portion of the DC stock ($750,000–$600,000). All of the gain of $150,000 is recognized under section 897 (a) because A's basis in Parcel P under section 334 (c) ($600,000) would exceed DC's basis in Parcel P ($400,000) by at least the amount of realized gain. A takes a basis of $750,000 in Parcel P.

(v) A is considered as having exchanged 25 percent (fair market value of equipment/fair market value of all property distributed) of the DC stock for the equipment. A realized gain of $50,000 on that portion of the DC stock ($250,000–$200,000). All of the gain of $50,000 is recognized under section 897 (a). A takes a basis of $250,000 in the equipment.

(c) *Distributions of U.S. real property interests by foreign corporations*—(1) *Recognition of gain required*. If a foreign corporation makes a distribution (including a distribution in liquidation or redemption) of a U.S. real property interest to a shareholder (whether foreign or domestic), then, except as provided in paragraph (c) (2), (3), or (4) of this section, the distributing corporation shall recognize gain (but not loss) on the distribution under section 897 (d) (1). The gain recognized shall be equal to the excess of the fair market value of the U.S. real property interest (as of the time of the distribution) over its adjusted basis. Except as otherwise provided, the distributee's basis in the distributed U.S. real property interest shall be determined under the otherwise applicable sections of the Code. The distributee (whether domestic or foreign) of a foreign corporation in a liquidation under section 332 shall take the foreign corporation's basis in the distributed U.S. real property interest increased by any gain recognized (and subject to U.S. income taxation) by the foreign corporation on the distribution of such U.S. real property interest.

(2) *Recognition of gain not required*—(i) *Statutory exception rule*. Under section 897(d)(2)(A), gain shall not be recognized by a distributing foreign corporation if—

(A) At the time of the receipt of the distributed U.S. real property interest, the distributee would be subject to U.S. income taxation on a subsequent disposition of the U.S. real property interest, determined in accordance with the rules of paragraph (d)(1) of this section;

(B) The basis of the distributed U.S. real property interest in the hands of the distributee is no greater than the adjusted basis of such property before the distribution, increased by the amount of gain (if any) recognized by the distributing corporation upon the

distribution and added to the adjusted basis under the otherwise applicable provisions; and

(C) The distributing corporation complies with the filing requirements of paragraph (d)(1)(iii) of this section.

(ii) *Section 332 liquidations*—(A) *In general.* A distributing foreign corporation that meets the requirements of paragraph (c)(2)(i) in a section 332(a) liquidation shall not recognize gain on the distribution of U.S. real property interests to a foreign corporation meeting the stock ownership requirements of section 332(b) if the distributing corporation complies with the procedural requirements of paragraph (d)(1)(iii). Whether a foreign corporation recognizes gain on the distribution of U.S. real property interests to a U.S. corporation meeting the stock ownership requirements of section 332(b) depends upon whether the U.S. corporation satisfies the subject to tax requirement provided in paragraph (d)(1)(i) (in addition to the procedural requirements of paragraph (d)(1)(iii)). With respect to section 332 distributions by a foreign corporation occurring after July 31, 1986, section 367(e)(2) shall not affect the application of section 337(a) (as in effect after the Tax Reform Act of 1986) and paragraph (c)(2)(i) of this section to the distribution of a U.S. real property interest.

(B) *Recognition of gain required in certain section 332 liquidations.* Notwithstanding the other rules of this paragraph (c), a foreign corporation shall, pursuant to the authority conferred by section 897(e)(2), recognize gain on its distribution after May 5, 1988 of a U.S. real property interest to a domestic corporation meeting the stock ownership requirements of section 332(b) if—

(*1*) The foreign corporation has not made an election under section 897(i), and any gain on the stock in the foreign corporation would be subject to U.S. taxation if an election were made on the date of the liquidation; and

(*2*) The distribution of the U.S. real property interest by the foreign corporation to the domestic corporation pursuant to section 332(a) occurs less than five years after the date of the last gain from the disposition of stock of the foreign corporation that would be subject to payment of tax under § 1.897–3(d)(2)(i) if an election under section 897(i) were made by the foreign corporation on the date of its liquidation.

With regard to the treatment of certain foreign corporations as domestic corporations under section 897(i), however, see §§ 1.897–3 and 1.897–8T.

(iii) *Examples.* The rules of this paragraph (c)(2) may be illustrated by the following examples.

Example 1. (i) DC, a domestic corporation, owns 100 percent of the stock of FC, a Country F corporation, FC's only asset is Parcel P, a U.S. real property interest, with a fair market value of $500x and an adjusted basis of $100x. In September 1987, FC liquidates under section 332(a) and transfers Parcel P to DC. The transitional rules contained in section 633 of the Tax Reform Act of 1986 concerning the repeal of the *General Utilities* doctrine would not be applicable to a subsequent distribution or disposition of assets by DC.

(ii) Assume that FC complies with the filing requirements of paragraph (d)(1)(iii). DC will be subject to U.S. income taxation on a subsequent disposition of Parcel P under the rules of paragraph (d)(1). The basis of Parcel P in the hands of DC will be $100x under section 334(b)(1), and thus no greater than the basis of Parcel P in the hands of FC. FC does not recognize any gain under the rules of paragraph (c)(1) of this section on the distribution because the exception of paragraph (d)(2)(i) applies.

Example 2. If in *Example* (1) the distribution by FC to DC occurred in September 1985, and DC sold or exchanged Parcel P under scctions 336(a) or 337(a) as in effect prior to the Tax Reform Act of 1986, then FC must recognize gain of $400x on the distribution of Parcel P. The gain must be recognized because Parcel P in the hands of DC is not considered subject to U.S. income taxation on a subsequent disposition under the rules of paragraph (d)(1) of this section.

(3) *Limitation of gain recognized under paragraph (c)(1) of this section for certain section 355 distributions*—(i) *In general.* Under paragraph (c)(1) of this section, a foreign corporation that distributes stock in a domestic corporation that constitutes a U.S. real property interest in a distribution to which section 355 applies shall recognize gain on the distribution to the extent that the fair market value of the distributed stock exceeds its adjusted basis in the hands of the distributing foreign corporation. The gain recognized shall be limited under this paragraph (c)(3), however, to the amount by which the aggregate

basis of the distributed stock in the hands of the distributees exceeds the aggregate adjusted basis of the distributed stock in the hands of the distributing corporation. The distributees' basis in the distributed U.S. real property interest shall be determined under the otherwise applicable provisions of section 358. (Thus, the distributees' basis in the distributed U.S. real property interest shall be determined without any increase for any gain recognized by the foreign corporation).

(ii) *Example*. The rules of paragraph (c)(3)(i) of this section may be illustrated by the following example.

Example. (i) C is a citizen and resident of Country F. C owns all of the stock of FC, a Country F corporation. The fair market value of the FC stock is 1000x, and C has a basis of 600x in the FC stock. Country F does not have an income tax treaty with the United States.

(ii) In a transaction qualifying as a distribution of stock of a controlled corporation under section 355(a), FC distributes to C all of the stock of DC, a U.S. real property holding corporation. C does not surrender any of the FC stock. The DC stock has a fair market value of 600x, and FC has an adjusted basis of 200x in the DC stock. After the distribution, the FC stock has a fair market value of 400x.

(iii) Under paragraph (c)(3)(i) of this section, FC must recognize gain on the distribution of the DC stock to C equal to the difference between the fair market value of the DC stock (600x) and FC's adjusted basis in the DC stock (200x). This results in a potential gain of 400x. Under section 358, C takes a 360x adjusted basis in the DC stock. Provided that FC complies with the filing requirements of paragraph (d)(1)(iii) of this section, the gain recognized by FC is limited under paragraph (c)(3)(i) to 160x because (A) this is the amount by which the basis of the DC stock in the hands of C (360x) exceeds the adjusted basis of the DC stock in the hands of FC (200x), and (B) at the time of receipt of the DC stock, C would be subject to U.S. taxation on a subsequent disposition of the stock.

(iv) C's adjusted basis in the DC stock is not increased by the 160x recognized by FC.

(4) *Distribution by a foreign corporation in certain reorganizations*—(i) *In general*. Under paragraph (c)(1) of this section, a foreign corporation that transfers property to another corporation in an exchange under section 361(a) for stock of a domestic corporation which is a United States real property holding corporation immediately after the transfer in a reorganization under section 368(a)(1) (C), (D), or (F) shall recognize gain under section 897(d)(1) on the distribution (whether actual or deemed) of the stock of the domestic corporation received by the foreign corporation to its shareholders (whether domestic or foreign). See §1.897–6T(a) of the regulations for the consequences to the foreign corporation of the exchange of its property for the domestic corporation stock.

(ii) *Statutory exception*. Pursuant to the exception provided in section 897(d)(2)(A), no gain shall be recognized by the foreign corporation on its distribution of the domestic corporation stock if—

(A) At the time of the distribution, the distributee (*i.e.*, the exchanging shareholder in the section 354 exchange) would be subject to U.S. taxation on a subsequent disposition of the stock of the domestic corporation, determined in accordance with the rules of paragraph (d)(1) of this section;

(B) The distributee's adjusted basis in the stock of the foreign corporation immediately before the distribution was no greater than the foreign corporation's basis in the stock of the domestic corporation determined under section 358; and

(C) The distributing corporation complies with the filing requirements of paragraph (d)(1)(iii) of this section.

(iii) *Regulatory limitation on gain recognized*. If the requirements of subdivisions (A) and (C) of paragraph (c)(4)(ii) are met, the amount of any gain recognized by the foreign corporation shall not exceed the excess of the distributee's adjusted basis in the stock of the foreign corporation immediately before the distribution over the foreign corporation's basis in the stock of the domestic corporation immediately before the distribution as determined under section 358.

(iv) *Examples*. The rules of paragraph (c)(4) of this section may be illustrated by the following examples.

Example 1. (i) A, a nonresident alien, organized FC, a Country W corporation, in September 1980 to invest in U.S. real estate. In 1986, FC's only asset is Parcel P, a U.S. real property interest with a fair market value of $600,000 and an adjusted basis to FC of

$200,000. Parcel P is subject to a mortgage with an outstanding balance of $100,000. The fair market value of the FC stock is $500,000, and A's adjusted basis in the stock is $100,000. FC does not have liabilities in excess of the adjusted basis in Parcel P. The United States does not have a treaty with Country W that entitles FC to nondiscriminatory treatment as described in section 1.897–3(b)(2) of the regulations.

(ii) Pursuant to a plan of reorganization under section 368(a)(1)(D), FC transfers Parcel P to DC, a newly formed domestic corporation, in exchange for DC stock. FC distributes the DC stock to A in exchange for A's FC stock.

(iii) FC's exchange of Parcel P for the DC stock is a disposition of a U.S. real property interest. Under § 1.897–6T(a)(1), there is an exchange of a U.S. real property interest (Parcel P) for another U.S. real property interest (DC stock) so that no gain is recognized on the exchange under section 897(e). DC takes FC's basis of $200,000 in Parcel P under section 362(b). Under section 358(a)(1), FC takes a $100,000 basis in the DC stock because FC's substituted basis of $200,000 in the DC stock is reduced by the $100,000 of liabilities to which Parcel P is subject.

(iv) Under section 897(d)(1) and paragraph (c)(4)(i) of this section, FC generally must recognize gain on the distribution of the DC stock received in exchange for FC's assets equal to the difference between the fair market value of the DC stock ($500,000) and FC's adjusted basis in the DC stock prior to the distribution ($100,000). This results in a potential gain of $400,000. Under section 358(a)(1), A takes a basis in the DC stock equal to its basis in the FC stock of $100,000. Provided that FC complies with the filing requirements of paragraph (d)(1)(iii) of this section, no gain is recognized by FC on the distribution of the DC stock under the statutory exception to the general rule of section 897(d)(1) provided in section 897(d)(2)(A) and paragraph (c)(4)(ii) of this section because (*1*) A's basis in the DC stock ($100,000) does not exceed FC's adjusted basis in the DC stock ($100,000) immediately prior to the distribution and (*2*) A, at the time of receipt of the DC stock, would be subject to U.S. taxation on a subsequent disposition of the stock.

(v) The FC stock in the hands of A is not a U.S. real property interest because FC is a foreign corporation that has not elected to be treated as a domestic corporation under section 897(i). Accordingly, the exchange of the FC stock by A for DC stock is not a disposition of a U.S. real property interest under section 897(a).

Example 2. The facts are the same as in Example 1, except that A purchased the FC stock in September 1983 for $100,000 from S, a nonresident alien, and that S had a basis of $40,000 in the FC stock at the time of the sale to A. The results are the same as in Example 1.

Example 3. (i) The facts are the same as in *Example* 1, except that A's adjusted basis in the FC stock prior to the reorganization is $300,000. Following the distribution, A takes its basis of $300,000 in the FC stock as its basis in the DC stock pursuant to section 358(a)(1).

(ii) FC does not qualify under the statutory exception of paragraph (c)(4)(ii) to the general recognition rule of section 897(d)(1) and paragraph (c)(4)(i) of this section because A's basis in the DC stock ($300,000) exceeds FC's adjusted basis in the DC stock ($100,000) immediately prior to the distribution. However, provided that FC complies with the filing requirements of paragraph (d)(1)(iii) of this section, the gain recognized by FC is limited to $200,000 under the regulatory limitation of gain provided by paragraph (c)(4)(iii). This is the excess of A's basis in the FC stock immediately before the distribution ($300,000) over A's adjusted basis in the DC stock immediately before the distribution ($100,000).

(iii) A takes a basis of $300,000 in the DC stock under section 358(a)(1). A's basis in the DC stock is not increased by the gain recognized by FC. DC takes a basis of $200,000 in Parcel P under section 362(b).

Example 4. (i) The facts are the same as in *Example* 3, except that the United States has an income tax treaty with Country W entitling FC to nondiscriminatory treatment under section 1.897–3(b)(2) of the regulations. A valid election under section 897(i) is made to treat FC as a U.S. corporation.

(ii) FC is treated as a domestic corporation for purposes of section 897 and is not required to recognize gain under section 897(d)(1) and paragraph (c)(4)(i) of this section on the distribution of the DC stock as described in *Example* 3. (If a valid section 897(i) election were not made, the result would be same as in *Example* 3.)

(iii) The FC stock in the hands of A is a U.S. real property interest because an election was made under section 897(i) to treat FC as a U.S. corporation. The exchange of the FC stock for DC stock by A is a disposition of a U.S. real property interest. Under section 897(e)(1) and paragraph (a) of § 1.897–6T, A does not recognize gain on the exchange because there is an exchange of a U.S. real property interest (the FC stock) for another U.S. real property interest (the DC stock). Under section 358(a)(1), A takes as its basis in the DC stock A's basis in the FC stock ($300,000).

(5) *Sales of U.S. real property interests by foreign corporations under section 337*. Section 337 as in effect prior to the Tax Reform Act of 1986 shall not apply to any sale or exchange (including a deemed section 337 sale pursuant to an

election under section 338(a) to treat a stock purchase as an asset acquisition) of a U.S. real property interest by a foreign corporation.

(6) *Section 897(l) credit.* If a foreign corporation adopts a plan of complete liquidation and if, solely by reason of section 897(d) and this section, section 337(a) (as in effect before the Tax Reform Act of 1986) does not apply to sales or exchanges of, or section 336 (as in effect before the Tax Reform Act of 1986) does not apply to distributions of, United States real property interests by the liquidating corporation, then—

(i) The amount realized by the shareholder on the distribution shall be increased by its proportionate share of the amount by which the tax imposed by chapter 1 of the Code, as modified by the provisions of any applicable U.S. income tax treaty, on the liquidating corporation would have been reduced if section 897(d) and this section had not been applicable, and

(ii) For purposes of the Code, the shareholder shall be deemed to have paid, on the last day prescribed by law for the payment of the tax imposed by subtitle A of the Code on the shareholder for the taxable year, an amount of tax equal to the amount of increase in the amount realized described in subdivison (i) of this paragraph (c).

The special rule provided by this paragraph (c)(5) applies only to shareholders who are United States citizens or residents, and who have held stock in the liquidating corporation continuously since June 18, 1980. This special rule also only applies for the first taxable year of any such shareholder in which the shareholder receives a distribution in complete liquidation from the foreign corporation.

(7) *Other applicable rules.* For rules concerning exemption of gain pursuant to a U.S. income tax treaty, withholding of tax from distributions, and other applicable rules, see paragraph (d) of this section. For the treatment of liquidations described in section 334(b)(2)(A) of certain foreign corporations acquired before November 6, 1980, see § 1.897–4.

(d) *Rules of general application*—(1) *Interests subject to taxation upon later disposition*—(i) *In general.* Pursuant to the otherwise applicable rules of this section and § 1.897–6T, nonrecognition of gain or loss may apply with respect to certain distribution or exchanges of U.S. real property interests if any gain from a subsequent disposition of the interests that are distributed or received by the transferor in the exchange would be included in the gross income of the distributee or transferor and be subject to U.S. taxation. Gain is considered subject to U.S. taxation if the gain is included on the income tax return of a U.S. tax paying entity even if there is no U.S. tax liability (for example, because of net operating losses or an investment tax credit). Gain is not considered subject to U.S. taxation if the gain is derived by a tax exempt entity. A real estate investment trust is considered to be a pass-through entity for purposes of the rule of taxability of this paragraph (d)(1)(i). Thus, for example, a tax exempt entity holding an interest in a real estate investment trust is not subject to tax. A domestic corporation (including a foreign corporation that makes an effective section 897(i) election after receipt of the U.S. real property interest) shall not be considered subject to U.S. taxation on a subsequent disposition of a U.S. real property interest if it received the U.S. real property interest prior to the effective date of the repeal of section 336(a) or 337(a) as in effect prior to the Tax Reform Act of 1986, unless the U.S. real property interest has not been sold or exchanged by the domestic corporation prior to such effective date in a transaction to which either section 336(a) or section 337(a) (as in effect prior to such effective date) applied. In addition, an interest shall be considered to be subject to U.S. taxation upon its subsequent disposition only if the requirements set forth in subdivision (iii) of this paragraph (d)(1) are met.

(ii) *Effects of income tax treaties*—(A) *Effect of treaty exemption from tax.* Except as otherwise provided in subdivision (C) of this paragraph (d)(1)(ii), a U.S. real property interest shall not be considered to be subject to U.S. taxation upon a subsequent disposition if, at the time of its distribution or exchange, the recipient is entitled pursuant to the provisions of a U.S. income tax treaty to an exemption from U.S.

taxation upon a disposition of the interest.

(B) *Effect of treaty reduction of tax*. If, at the time of a distribution or exchange, a distributee of a U.S. real property interest in a distribution or a transferor who receives a U.S. real property interest in an exchange would be entitled pursuant to the provisions of a U.S. income tax treaty to reduced U.S. taxation upon the disposition of the interest, then a portion of the interest received shall be treated as an interest subject to U.S. taxation upon its disposition, and, therefore, that portion shall be entitled to nonrecognition treatment under the rules of this section or §1.897–6T. The portion of the interest that is treated as subject to U.S. taxation is determined by multiplying the fair market value of the interest by a fraction. The numerator of the fraction is the amount of tax that would be due pursuant to the provisions of the applicable U.S. income tax treaty upon the recipient's disposition of the interest, determined as of the date of the distribution or transfer. The denominator of the fraction is the amount of tax that would be due upon such disposition but for the provisions of the treaty. However, nonrecognition treatment may be preserved in accordance with the provisions of subdivision (C) of this paragraph (d)(1)(ii). With regard to the provisions of this paragraph, see Article XIII (9) of the United States-Canada Income Tax Convention.

(C) *Waiver of treaty benefits to preserve nonrecognition*. Notwithstanding the provisions of subdivisions (A) and (B) of this paragraph (d)(1)(ii), an interest shall be considered to be subject to U.S. taxation upon its subsequent disposition if, in accordance with paragraph (d)(1)(iii)(F) of this section, the recipient waives the benefits of a U.S. income tax treaty that would otherwise entitle the recipient to an exemption from (or reduction of) U.S. tax upon a disposition of the interest.

(iii) *Procedural requirements*. If a U.S. real property interest is distributed or transferred after December 31, 1987, the transferor or distributor (that is a nonresident alien individual or a foreign corporation) shall file an income tax return for the taxable year of the distribution or transfer. Also, if a U.S. real property interest is distributed or transferred in a transaction before January 1, 1988, with respect to which nonrecognition treatment would not have been available under the express provisions of section 897 (d) or (e) of the Code but is available under the provisions of this section or §1.897–6T, then the person that would otherwise be subject to tax by reason of the operation of section 897 must file an income tax return for the taxable year of the distribution or transfer. This requirement is satisfied by filing a tax return or an amended tax return for the year of the distribution or transfer by May 5, 1989, or by the date that the filing of the return is otherwise required. The person filing the return must attach thereto a document setting forth the following:

(A) A statement that the distribution or transfer is one to which section 897 applies;

(B) A description of the U.S. real property interest distributed or transferred, including its location, its adjusted basis in the hands of the distributor or tranferor immediately before the distribution or transfer, and the date of the distribution or transfer;

(C) A description of the U.S. real property interest received in an exchange;

(D) A declaration signed by an officer of the corporation that the distributing foreign corporation has substantiated the adjusted basis of the shareholder in its stock if the distributing corporation has nonrecognition or recognition limitation under paragraph (c) (3) or (4) of this section;

(E) The amount of any gain recognized and tax withheld by any person with respect to the distribution or transfer;

(F) [Reserved]. For further guidance, see §1.897–5(d)(1)(iii)(F).

(G) The treaty and article (if any) under which the distributee or transferor would be exempt from U.S. taxation on a sale of the distributed U.S. real property interest or the U.S. real property interest received in the transfer; and

(H) A declaration, signed by the distributee or transferor or its authorized legal representative, that the distributee or transferor shall treat any

subsequent sale, exchange, or other disposition of the U.S. real property interest as a disposition that is subject to U.S. taxation, notwithstanding the provisions of any U.S. income tax treaty or intervening change in circumstances.

A person who has provided or filed a notice described in § 1.1445–2(d)(2)(iii) or § 1.1445–5(b)(2)(ii) in connection with a transaction may satisfy the requirement of this paragraph (d)(1)(iii) by attaching to his return a copy of that notice together with any information or declaration required by this subdivision not contained in that notice.

(2) *Treaty exception to imposition of tax*. If gain that would be currently recognized pursuant to the provisions of this section or § 1.897–6T is subject to an exemption from (or reduction of) U.S. tax pursuant to a U.S. income tax treaty, then gain shall be recognized only as provided by that treaty, for dispositions occurring before January 1, 1985. For dispositions occurring after December 31, 1984, all gain shall be recognized as provided in section 897 and the regulations thereunder, except as provided by Articles XIII (9) and XXX (5) of the United States-Canada Income Tax Convention or other income tax treaty entered into force after June 6, 1988.

With regard to Article XXX (5) of the Income Tax Treaty with Canada, see, Rev. Rul. 85–76, 1985–1 C.B. 409. With regard to basis adjustments for certain related person transactions, see, § 1.897–6T(c)(3).

(3) *Withholding*. Under sections 1441 and 1442, as modified by the provisions of any applicable U.S. income tax treaty, a corporation must withhold tax from a dividend distribution to which section 301 applies to a shareholder that is a foreign person, if the dividend is considered to be from sources inside the United States. For a description of dividends that are considered to be from sources inside the United States, see section 861(a)(2). Under section 1445, withholding is required with respect to certain dispositions and distributions of U.S. real property interests.

(4) *Effect on earnings and profits*. With respect to adjustments to earnings and profits for gain recognized to a distributing corporation on a distribution, see section 312 and the regulations thereunder.

(e) *Effective date*. Except as otherwise specifically provided in the text of these regulations, this section shall be effective for transfers, exchanges, distributions and other dispositions occurring after June 18, 1980.

[T.D. 8198, 53 FR 16217, May 5, 1988; 53 FR 18022, May 19, 1988; T.D. 9082, 68 FR 46084, Aug. 5, 2003]

§ 1.897–6T Nonrecognition exchanges applicable to corporations, their shareholders, and other taxpayers, and certain transfers of property in corporate reorganizations (temporary).

(a) *Nonrecognition exchanges*—(1) *In general*. Except as otherwise provided in this section and in § 1.897–5T, for purposes of section 897(e) any nonrecognition provision shall apply to a transfer by a foreign person of a U.S. real property interest on which gain is realized only to the extent that the transferred U.S. real property interest is exchanged for a U.S. real property interest which, immediately following the exchange, would be subject to U.S. taxation upon its disposition, and the transferor complies with the filing requirements of paragraph (d)(1)(iii) of § 1.897–5T. No loss shall be recognized pursuant to section 897(e) or the rules of this section unless such loss is otherwise permitted to be recognized. In the case of an exchange of a U.S. real property interest for stock in a domestic corporation (that is otherwise treated as a U.S. real property interest), such stock shall not be considered a U.S. real property interest unless the domestic corporation is a U.S. real property holding corporation immediately after the exchange. Whether an interest would be subject to U.S. taxation in the hands of the transferor upon its disposition shall be determined in accordance with the rules of § 1.897–5T(d)(1).

(2) *Definition of ''nonrecognition'' provision*. A ''nonrecognition provision'' is any provision of the Code which provides that gain or loss shall not be recognized if the requirements of that provision are met. Nonrecognition provisions relevant to this section include, but are not limited to, sections 332, 351,

354, 355, 361, 721, 731, 1031, 1033, and 1036. For purposes of section 897(e), sections 121 and 453 are not nonrecognition provisions.

(3) *Consequence of nonapplication of nonrecognition provisions.* If a nonrecognition provision does not apply to a transaction, then the U.S. real property interest transferred shall be considered exchanged pursuant to a transaction that is subject to U.S. taxation by reason of the operation of section 897. See, however, §1.897–5T (d)(2) with respect to the treaty exceptions to the imposition of tax. If a U.S. real property interest is exchanged for an interest the disposition of which is only partially subject to taxation under chapter 1 of the Code (as modified by the provisions of any applicable U.S. income tax treaty), then any nonrecognition provision shall apply only to the extent that the interest received in the exchange would be subject to taxation under chapter 1 of the Code, as modified. For example, the exchange of a U.S. real property interest for an interest in a partnership will receive nonrecognition treatment pursuant to section 721 only to the extent that a disposition of the partnership interest will be subject to U.S. taxation by reason of the operation of section 897(g).

(4) *Section 355 distributions treated as exchanges.* If a domestic corporation, stock in which is treated as a U.S. real property interest, distributes stock in a foreign corporation or stock in a domestic corporation that is not a U.S. real property holding corporation to a foreign person under section 355(a), then the foreign person shall be considered as having exchanged a proportionate part of the stock in the domestic corporation that is treated as a U.S. real property interest for stock that is not treated as a U.S. real property interest.

(5) [Reserved]

(6) *Determination of basis.* If a nonrecognition provision applies to the transfer of a U.S. real property interest pursuant to the provisions of this section, then the basis of the property received in the exchange shall be determined in accordance with the rules generally applicable with respect to such nonrecognition provision. Similarly, the basis of the exchanged property in the hands of the transferee shall be determined in accordance with the rules that generally apply to such transfer.

(7) *Examples.* The rules of paragraphs (a) (1) through (6) of this section may be illustrated by the following examples. In each instance, the filing requirements of paragraph (d)(1)(iii) of §1.897–5T have been satisfied.

Example 1. (i) A is a citizen and resident of Country F with which the U.S. does not have an income tax treaty. A owns Parcel P, a U.S. real property interest, with a fair market value of $500,000 and an adjusted basis of $300,000. A transfers Parcel P to DC, a newly formed U.S. real property holding corporation wholly owned by A, in exchange for DC stock.

(ii) Under paragraph (a)(1) of this section, A has exchanged a U.S. real property interest (Parcel P) for another U.S. real property interest (DC stock) which is subject to U.S. taxation upon its disposition. The nonrecognition provisions of section 351(a) apply to A's transfer of Parcel P.

(iii) Under paragraph (a)(6) of this section, the basis of the DC stock received by A is determined in accordance with the rules generally applicable to the transfer. A takes a $300,000 adjusted basis in the DC stock under the rules of section 358(a)(1).

Examples 2–3. [Reserved]

Example 4. (i) B is a citizen and resident of Country F with which the U.S. does not have an income tax treaty. B owns stock in DC1, a U.S. real property holding corporation. In a reorganization qualifying for nonrecognition under section 368(a)(1)(B), B exchanges the DC1 stock under section 354(a) for stock in DC2, a U.S. real property holding corporation.

(ii) A does not recognize any gain under paragraph (a)(1) of this section on the exchange of the DC1 stock for DC2 stock because there is an exchange of a U.S. real property interest (the DC1 stock) for another U.S. real property interest (the DC2 stock) which is subject to U.S. taxation upon its disposition.

Example 5. (i) C is a citizen and resident of Country F with which the U.S. does not have an income tax treaty. C owns all of the stock of DC, a U.S. real property holding corporation. The fair market value of the DC stock is 500x, and C has a basis of 100x in the DC stock.

(ii) In a transaction qualifying as a distribution of stock of a controlled corporation under section 355(a), DC distributes to C all of the stock of FC, a foreign corporation that has not made a section 897(i) election. C does not surrender any of the DC stock. The FC stock has a fair market value of 200x. After

the distribution, the DC stock has a fair market value of 300x.

(iii) Under the rules of paragraph (a)(4) of this section, C is considered to have exchanged DC stock with a fair market value of 200x and an adjusted basis of 40x for FC stock with a fair market value of 200x. Because the FC stock is not a U.S. real property interest, C must recognize gain of 160x under section 897(a) on the distribution. C takes a basis of 200x in the FC stock. C's basis in the DC stock is reduced to 60x pursuant to section 358(c).

Example. (i) A is an individual citizen and resident of Country F. F has an income tax treaty with the United States that exempts gain from the sale of stock, but not real property, by a resident of F from U.S. taxation. In 1981, A transferred Parcel P, an appreciated U.S. real property interest, to DC, a U.S. real property holding corporation, in exchange for DC stock. A owned all of the stock of DC.

(ii) Under the rules of paragraph (a)(1) of this section, A must recognize gain on the transfer of Parcel P. Even though there is an exchange of a U.S. real property interest for another U.S. real property interest, there is gain recognition because the U.S. real property interest received (the DC stock) would not have been subject to U.S. taxation upon a disposition immediately following the exchange. A may not convert a U.S. real property interest that was subject to taxation under section 897 into a U.S. real property interest that could be sold without taxation under section 897 due to a treaty exemption.

Example 7. (i) A, a nonresident alien, organized FC1, a Country W corporation in September 1980 to invest in U.S. real property. FC1's only asset is Parcel P, a U.S. real property interest with a fair market value of $500,000 and an adjusted basis of $200,000. The FCI stock has a fair market value of $500,000 and A's basis in the FC1 stock is $100,000. The United States does not have a treaty with Country W.

(ii) A, organized FC2, a Country W corporation in July 1987. FC2 organized DC in August 1987. Pursuant to a plan of reorganization under section 368 (a)(1)(C), FC1 transfers Parcel P to DC in exchange for FC2 voting stock. As a result of the transfer, DC is a U.S. real property holding corporation wholly owned by FC2. The FC2 stock used by DC in the acquisition had been transferred by FC2 to DC as part of the plan of reorganization. FC1 distributes the FC2 stock to A in exchange for A's FC1 stock.

(iii) FC1's exchange of Parcel P for the FC2 stock under section 361(a) is a disposition of a U.S. real property interest. FC1 must recognize gain of $300,000 under section 897(e) and paragraph (a)(1) of this section on the exchange because the FC2 stock received in exchange for Parcel P is not a U.S. real property interest.

(iv) Under section 362(b), DC takes a basis of $500,000 in Parcel P. FC2 takes a basis of $500,000 in the DC stock. A takes a basis of $100,000 in the FC2 stock under section 358(a)(1). Section 897(d) and paragraph (c)(1) of §1.897–5T do not apply to FC1's distribution of the FC2 stock because the FC2 stock is not a U.S. real property interest.

Example 8. (i) The facts are the same as in *Example 7*, except that the United States has a treaty with Country W that entitles FC1 and FC2 to nondiscriminatory treatment as described in §1.897–3(b)(2). FC1, but not FC2, makes a valid section 897(i) election prior to the transaction.

(ii) FC1's transfer of Parcel P to DC in exchange for FC2 stock is not subject to section 897(e) and paragraph (a)(1) of this section because FC1 made an election under section 897(i). DC takes a basis of $200,000 in Parcel P under section 362(b).

(iii) FC1's distribution of the FC2 stock to A in exchange for the FC1 stock is not subject to the section 897(d) and paragraph (c)(1) of §1.897–5T because FC1 made an election under section 897(i).

(iv) A must recognize gain on the exchange under section 354(a) of the FC1 stock for the FC2 stock. A exchanged a U.S. real property interest (the FC1 stock) for an interest which is not a U.S. real property interest (the FC2 stock). A recognizes gain of $400,000. Under section 1012, A takes a $500,000 basis in the FC2 stock.

Example 9. (i) The facts are the same as in *Example 7* except that the United States has a treaty with Country W that entitles FC1 and FC2 to nondiscriminatory treatment as described in §1.897–3(b)(2). FC2, but not FC1, makes a valid section 897(i) election prior to the transaction.

(ii) FC1's exchange of Parcel P for the FC2 stock under section 361(a) is a disposition of a U.S. real property interest. FC1 does not recognize any gain under section 897(e) and paragraph (a)(1) of this section because there is an exchange of a U.S. real property interest (Parcel P) for another U.S. real property interest (the FC2 stock). DC takes a basis of $200,000 in Parcel P under section 362(b). FC2 takes a basis of $200,000 in the DC stock.

(iii) FC1's distribution of the FC2 stock to A in exchange for the FC1 stock is subject to section 897(d) and paragraph (c)(1) of §1.897–5T. Because A takes a basis of $100,000 in the FC2 stock under section 358(a) (which is less than the $200,000 basis of the FC2 stock in the hands of FC1), and A would be subject to U.S. taxation under section 897(a) on a subsequent disposition of the FC2 stock, FC1 does not recognize any gain under paragraph (c)(1) of §1.897–5T due to the statutory exception of paragraph (c)(2)(i) of that section, provided that FC1 complies with the filing requirements of paragraph (d)(1)(C) of §1.897–5T.

(iv) Since, the FC1 stock was not a U.S. real property interest, its disposition by A in

the section 354(a) exchange for FC2 stock is not subject to section 897(e) and paragraph (a)(1) of this section.

Example 10. (i) The facts are the same as in *Example 7*, except that the United States has a treaty with Country W that entitles FC1 and FC2 to nondiscriminatory treatment as described in § 1.897–3(b)(2). FC1 and FC2 made valid section 897(i) elections prior to the transactions.

(ii) FC1's transfer of Parcel P to DC in exchange for FC2 stock is not subject to section 897(e) and paragraph (a)(1) of this section because FC1 made an election under section 897(i). DC takes a basis of $200,000 in Parcel P under section 362(a). FC2 takes a basis of $200,000 in the DC stock.

(iii) FC1's distribution of the FC2 stock to A in exchange for the FC1 stock is not subject to section 897(d) and paragraph (c)(1) of § 1.897–5T because FC1 made an election under section 897(i).

(iv) A does not recognize any gain on the exchange of the FC1 stock for the FC2 stock under section 354(a). Under paragraph (a)(1) of this section, there is an exchange of a U.S. real property interest (FC1 stock) for another U.S. real property interest (FC2 stock). A takes a basis of $100,000 in the FC2 stock under section 358(a).

(8) *Treatment of nonqualifying property*—(i) *In general.* If, under paragraph (a)(1) of this section, a nonrecognition provision would apply to an exchange but for the fact that nonqualifying property (cash or property other than U.S. real property interests) is received in addition to property (U.S. real property interests) that is permitted to be received under paragraph (a)(1) of this section, then the transferor shall recognize gain under this section equal to the lesser of—

(A) The sum of the cash received plus the fair market value of the nonqualifying property received, or

(B) The gain realized with respect to the U.S. real property interest transferred. However, no loss shall be recognized pursuant to this paragraph (a)(8) unless such loss is otherwise permitted to be recognized.

(ii) *Treatment of mixed exchanges.* In a mixed exchange where both a U.S. real property interest and other property (including cash) is transferred in exchange both for property the receipt of which would qualify for nonrecognition treatment pursuant to paragraph (a)(1) of this section and for other property (including cash) which would not so qualify, the transferor will recognize gain in accordance with the rules set forth in subdivisions (A) through (C) of this paragraph (a)(8)(ii).

(A) *Allocation of nonqualifying property.* The amount of nonqualifying property (including cash) considered to be received in exchange for U.S. real property interests shall be determined by multiplying the fair market value of the nonqualifying property received by a fraction (''real property fraction''). The numerator of the fraction is the fair market value of the U.S. real property interest transferred in the exchange. The denominator of the fraction is the fair market value of all property transferred in the exchange.

(B) *Recognition of gain.* The amount of gain that must be recognized, and that shall be subject to U.S. taxation by reason of the operation of section 897, shall be equal to the lesser of:

(*1*) The amount determined under subdivision (A) of this paragraph (a)(8)(ii), or

(*2*) The gain or loss realized with respect to the U.S. real property interest exchanged.

(C) *Treatment of other amounts.* The treatment of other amounts received in a mixed exchange shall be determined as follows:

(*1*) The amount of nonqualifying property (including cash) considered to be received in exchange for property (including cash) other than U.S. real property interests shall be treated in the manner provided in the relevant nonrecognition provision. Such amounts shall be determined by subtracting the amount determined under subdivision (A) of this paragraph (a)(8)(ii) from the total amount of nonqualifying property received in the exchange.

(*2*) The amount of qualifying property considered to be received in exchange for U.S. real property interests shall be treated in the manner provided in paragraph (a)(1) of this section. Such amount shall be determined by multiplying the total fair market value of qualifying property received in the exchange by the real property fraction described in subdivision (A) of this paragraph (a)(8)(ii).

(*3*) The amount of qualifying property considered to be received in exchange for property other than U.S.

real property interests shall be treated in the manner provided in the relevant nonrecognition provision. Such amount shall be determined by subtracting the amount determined under subdivision (*2*) of this paragraph (a)(8)(ii)(C) from the total fair market value of qualifying property received in the exchange.

(iii) *Example*. The rules of paragraph (a)(8)(ii) of this section may be illustrated by the following example.

Example. (i) A is an individual citizen and resident of country F. Country F does not have an income tax treaty with the United States. A is the sole proprietor of a business located in the United States, the assets of which consist of a U.S. real property interest with a fair market value of $1,000,000 and an adjusted basis of $700,000, and equipment used in the business with a fair market value of $500,000 and an adjusted basis of $250,000. A decides to incorporate the business, and on January 1, 1987, A transfers his assets to domestic corporation DC in exchange for 100 percent of the stock of DC, with a fair market value of $900,000. In addition, A receives a long term note (constituting a security) from DC for $600,000, bearing arm's length interest and repayment terms. DC has no assets other than those received in the exchange with A. Pursuant to section 897(c)(2) and § 1.897–2, DC is a U.S. real property holding corporation. Therefore, the stock of DC is a U.S. real property interest. Assume that the note from DC constitutes an interest in the corporation solely as a creditor as provided by § 1.897–1(d)(4) of the regulation. A complies with the filing requirements of paragraph (d)(1)(iii) of § 1.897–5T.

(ii) Because the note from DC would not be subject to U.S. taxation upon its disposition, it is nonqualifing property for purposes of determining whether A is entitled to receive nonrecognition treatment pursuant to section 351 with respect to his exchange of the U.S. real property interest. Thus, A must recognize gain in the manner provided in paragraph (a)(8)(ii) of this section. Pursuant to paragraph (a)(8)(ii)(A), the amount of nonqualifying property received in exchange for the real property interests is determined by multiplying the fair market value of such property ($600,000) by the real property fraction. The numerator of the fraction is $1,000,000, the fair market value of the real property transferred by A. The demoninator is $1,500,000, the fair market value of all property transferred by A. Thus, A is considered to have received $400,000 of the note in exchange for the real property ($600,000 × $1,000,000/$1,500,000). Pursuant to paragraph (a)(8)(ii)(B), A must recognize the lesser of the amount initially determined or the gain realized with respect to the U.S. real property interest. Therefore, A must recognize the $300,000 gain realized with respect to the real property.

(iii) Pursuant to paragraph (a)(8)(ii)(C) of this section, A is considered to have received $200,000 of the note in exchange for equipment ($600,000 [total value of note received] minus $400,000 [portion of note received in exchange for real property]), $600,000 of the stock in exchange for real property ($900,000 [total value of stock received] times $1,000,000/1,500,000) [proportion of property exchanged consisting of real property]), and $300,000 of the stock in exchange for equipment ($900,000 [total value of stock received] minus $600,000 [portion of stock received in exchange for real property]). All three amounts are entitled to nonrecognition treatment pursuant to section 351.

(iv) Pursuant to paragraph (a)(2) of this section, A's basis in the stock and note received and DC's basis in the U.S. real property interest and equipment will be determined in accordance with the generally applicable rules. The $400,000 portion of the note received in exchange for the real property interest is other property. Pursuant to section 358(a)(2), A takes a fair market value ($400,000) basis for that portion of the note. Pursuant to section 358(a)(1), A's basis in the property received without the recognition of gain (the DC stock and the other portion of the note) will be equal to the basis of the property transferred ($950,000 [$700,000 basis of U.S. real property interest plus $250,000 basis of equipment]), decreased by the fair market value of the other property received ($400,000 portion of the note), and increased by the amount of gain recognized to A on the transaction ($300,000). Thus, A's basis in the stock and the nonrecognition portion of the note is $850,000 ($950,000–$400,000 + $300,000). Under § 1.358–2(b)(2) of the regulations, the $850,000 is allocated between the stock and the nonrecognition portion of the note in proportion to their fair market values. A takes a basis of $697,000 in the DC stock ($850,000 × 900,000/1,100,000). A takes a basis of $153,000 in the nonrecognition portion of the note ($850,000 × 200,000/1,100,000). A's basis in the note is $553,000 ($400,000 + $153,000). DC's basis in the property received from A will be determined under section 362(a). DC takes a basis of $1,000,000 in the real property interest (A's basis of $700,000 increased by the $300,000 of gain recognized by A on it). DC takes a basis of $250,000 in the equipment (A's basis of $250,000).

(9) *Treaty exception to imposition of tax*. If gain that would be currently recognized pursuant to the provisions of this section is subject to an exemption from, or reduction of, U.S. tax pursuant to a U.S. income tax treaty, then

gain shall be recognized only as provided by that treaty for dispositions occurring before January 1, 1985. For dispositions occurring after December 31, 1984, all gain shall be recognized as provided in section 897 and the regulations thereunder, except as provided by Articles XII (9) and XXX (5) of the United States-Canada Income Tax Convention or other income tax treaty entered into after June 6, 1988. In regard to Article XXX (5) the Income Tax Treaty with Canada, see, Rev. Rul. 85–76, 1985–1 C.B. 409.

(b) *Certain foreign to foreign exchanges*—(1) *Exceptions to the general rule*. Notwithstanding the provisions of paragraph (a)(1) of this section and pursuant to authority conferred by section 897(e)(2), a foreign person shall not recognize gain, in the instances described in paragraph (b)(2) of this section, on the transfer of a U.S. real property interest to a foreign corporation in exchange for stock in a foreign corporation, but only if the transferee's subsequent disposition of the transferred U.S. real property interest would be subject to U.S. taxation, as determined in accordance with the provisions of §1.897–5T(d)(1), if the filing requirements of paragraph (d)(1)(iii) of §1.897–5T have been satisfied, if one of the five conditions set forth in paragraph (b)(2) exists, and if one of the following three forms of exchange takes place.

(i) The exchange is made by a foreign corporation pursuant to section 361(a) in a reorganization described in section 368(a)(1) (D) or (F) and there is an exchange of the transferor corporation stock for the transferee corporation stock under section 354(a); or

(ii) The exchange is made by a foreign corporation pursuant to section 361(a) in a reorganization described in section 368(a)(1)(C); there is an exchange of the transferor corporation stock for the transferee corporation stock (or stock of the transferee corporation's parent in the case of a parenthetical C reorganization) under section 354(a); and the transferor corporation's shareholders own more than fifty percent of the voting stock of the transferee corporation (or stock of the transferee corporation's parent in the case of a parenthetical C reorganization) immediately after the reorganization; or

(iii) The U.S. real property interest exchanged is stock in a U.S. real property holding corporation; the exchange qualifies under section 351(a) of section 354(a) in a reorganization described in section 368(a)(1)(B); and immediately after the exchange, all of the outstanding stock of the transferee corporation (or stock of the transferee corporation's parent in the case of a parenthetical B reorganization) is owned in the same proportions by the same nonresident alien individuals and foreign corporations that, immediately before the exchange, owned the stock of the U.S. real property holding corporation.

If, however, a nonresident alien individual or foreign corporation which received stock in an exchange described in subdivision (iii) of this paragraph (b)(1) (or the transferee corporation's parent) disposes of any of such foreign stock within three years from the date of its receipt, then that individual or corporation shall recognize that portion of the gain realized with respect to the stock in the U.S. real property holding corporation for which foreign stock disposed of was received.

(2) *Applicability of exception*. The exception to the provisions of paragraph (a)(1) provided by paragraph (b)(1) shall apply only if one of the following five conditions exists.

(i) Each of the interests exchanged or received in a transferor corporation or transferee corporation would not be a U.S. real property interest as defined in §1.897–1(c)(1) if such corporations were domestic corporations; or

(ii) The transferee corporation (and the transferee corporation's parent in the case of a parenthetical B or C reorganization) is incorporated in a foreign country that maintains an income tax treaty with the United States that contains an information exchange provision; the transfer occurs after May 5, 1988; and the transferee corporation (and the transferee corporation's parent in the case of a parenthetical B or C reorganization) submit a binding waiver of all benefits of the respective income tax treaty (including the opportunity to make an election under section 897 (i)), which must be attached to

each of the transferor and transferee corporation's income tax returns for the year of the transfer; or

(iii) The transferee foreign corporation (and the transferee corporation's parent in the case of a parenthetical B or C reorganization) is a qualified resident as defined in section 884(e) and any regulations thereunder of the foreign country in which it is incorporated; or

(iv) The transferee foreign corporation (and the transferee corporation's parent in the case of a parenthetical B or C reorganization) is incorporated in the same foreign country as the transferor foreign corporation; and there is an income tax treaty in force between that foreign country and the United States at the time of the transfer that contains an exchange of information provision; or

(v) The transferee foreign corporation is incorporated in the same foreign country as the transferor foreign corporation; and the transfer is incident to a mere change in identity, form, or place of organization of one corporation under section 368(a)(1)(F).

For purposes of any election by a transferee foreign corporation (or the transferee corporation's parent in the case of a parenthetical C reorganization) to be treated as a domestic corporation under section 897(i) and §1.897–3 where the exchange was described in subdivisions (i) or (ii) of paragraph (b)(1) of this section, any prior dispositions of the transferor foreign corporation stock will be subject to the requirements of §1.897–3(d)(2) upon an election under section 897(i) by the transferee foreign corporation (or the transferee corporation's parent in the case of a parenthetical C reorganization).

(3) *No exceptions*. No exception to recognition of gain under paragraph (a)(1) of this section is provided for the transfer of a U.S. real property interest by a foreign person to a foreign corporation in exchange for stock in a foreign corporation other than as provided in this paragraph (b). Thus, no exception is provided where—

(i) Such exchange is made pursuant to section 351 and the U.S. real property interest transferred is not stock in a U.S. real property holding corporation; or

(ii) Such exchange is made pursuant to section 361(a) in a reorganization described in section 368(a)(1) that does not qualify for nonrecognition of gain under this paragraph (b). With regard to the treatment of certain foreign corporations as domestic corporations under section 897(i), see §§1.897–3 and 1.897–8T.

(4) *Examples*. The rules of paragraph (b)(1) and (2) of this section may be illustrated by the following examples. In each instance, the filing requirements of paragraph (d)(1)(iii) of §1.897–5T have been satisfied.

Example 1. (i) FC is a Country F corporation that has not made a section 897 (i) election. FC owns Parcel P, a U.S. real property interest, with a fair market value of $450x and an adjusted basis of 100x.

(ii) FC transfers Parcel P to FS, its wholly owned Country F subsidiary, in exchange for FS stock under section 351 (a). FS has not made a section 897(i) election. Under the rules of paragraph (a)(1) of this section, FC must recognize gain of 350x under section 897 (a) because the FS stock received in the exchange is not a U.S. real property interest. No exception to the recognition rule of paragraph (a)(1) is provided under this paragraph (b) for a transfer under section 351 (a) of a U.S. real property interest (that is not stock in a U.S. real property holding corporation) by a foreign corporation to another foreign corporation in exchange for stock to the transferee corporation.

Example 2. (i) FC is a Country F corporation that has not made a section 897(i) election. FC owns several U.S. real property interests that have appreciated in value since FC purchased the interests. FP, a Country F corporation, owns all of the outstanding stock of FC. Country F maintains an income tax treaty with the United States.

(ii) For valid business purposes, FC transferred substantially all of its assets including all of its U.S. real property interests to FS in 1989 under section 361(a) in a reorganization in exchange for FS stock. FS is a newly formed Country F corporation that is owned by FC. The transfer qualifies as a reorganization under section 368(a)(1)(D). FC immediately distributes the FS stock to FP in exchange for the FC stock and FC dissolves. FP has no gain or loss on the exchange of the FC stock for the FS stock under section 354(a).

(iii) Under the rules of paragraph (b)(1)(i) of this section, FC does not recognize any gain on the transfer of the U.S. real property

interests to FS under section 361(a) in the reorganization under section 368(a)(1)(D) because FS would be subject to U.S. taxation on a subsequent disposition of the interests, as required by paragraph (b)(1) of this section; there is an exchange of stock under section 354(a), as required by paragraph (b)(1)(i); and FC and FS are incorporated in Country F which maintains an income tax treaty with the United States, as required by paragraph (b)(2)(iv).

(5) *Contributions of property*. A foreign person that contributes a U.S. real property interest to a foreign corporation as paid in surplus or as a contribution to capital (including a contribution provided in section 304(a)) shall be treated, for purposes of section 897(j) and this section, as exchanging the U.S. real property interest for stock in the foreign corporation.

(c) *Denial of nonrecognition with respect to certain tax avoidance transfers*—(1) *In general*. The provisions of § 1.897–5T and paragraphs (a) and (b) of this section are subject to the rules of this paragraph (c).

(2) *Certain transfers to domestic corporations*—(i) *General rule*. If a foreign person transfers property, that is not a U.S. real property interest, to a domestic corporation in a nonrecognition exchange, where—

(A) The adjusted basis of such property transferred exceeded its fair market value on the date of the transfer to the domestic corporation;

(B) The property transferred will not immediately be used in, or held by the domestic corporation for use in, the conduct of a trade or business as defined in § 1.897–1(f); and

(C) Within two years of the transfer to the domestic corporation, the property transferred is sold at a loss;

then, it will be presumed, absent clear and convincing evidence to the contrary, that the purpose for transferring the loss property was the avoidance of taxation on the disposition of U.S. real property interests by the domestic corporation. Any loss recognized by the domestic corporation on the sale or exchange of such property shall not be used by the domestic corporation, either by direct offset or as part of a net operating loss or capital loss carryback or carryover to offset any gain recognized from the sale or exchange of a U.S. real property interest by the domestic corporation.

(ii) *Example*. The rules of paragraph (c)(2)(i) of this section may be illustrated by the following example.

Example. A is an individual citizen and resident of country F, which does not have an income tax treaty with the U.S. On January 1, 1987, A transfers a U.S. real property interest with a basis of $100,000 and a fair market value of $600,000 to domestic corporation DC in exchange for all of the stock of DC. On October 20, 1987, A transfers stock of a publicly traded domestic corporation with a basis in his hands of $900,000 and a fair market value of $500,000, in exchange for additional stock of DC. The stock of the publicly traded domestic corporation does not constitute an asset used or held for use in DC's trade or business. If DC sells the stock of the publicly traded domestic corporation before October 20, 1989 and recognizes a loss, the loss may not be used to offset any gain recognized on the sale of the U.S. real property interests by DC.

(3) *Basis adjustment for certain related person transactions*. In the case of any disposition after December 31, 1979, of a U.S. real property interest to a related person (within the meaning of section 453(f)(1)), the basis of the interest in the hands of the person acquiring such interest shall be reduced by the amount of any gain which is not subject to taxation under section 871(b)(1) or 882(a)(1) because the disposition occurred before June 19, 1980 or because of any treaty obligation of the United States. If a foreign corporation makes an election under section 897(i), and the stock of such corporation was transferred between related persons after December 31, 1979 and before June 19, 1980, then such stock shall be treated as a U.S. real property interest solely for purposes of this paragraph (c)(3).

(4) *Rearrangement of ownership to gain treaty benefit*. A foreign person who directly or indirectly owns a U.S. real property interest may not directly or indirectly rearrange the incidents of ownership of the U.S. real property interest through the use of nonrecognition provisions in order to gain the benefit of a treaty exemption from taxation. Such nonrecognition will not apply to the foreign transferor. The transferor will recognize gain but not loss on the transfer under section 897(a).

(d) *Effective date.* Except as specifically provided otherwise in the text of the regulations, paragraphs (a) through (c) shall be effective for transfers, exchanges and other dispositions occurring after June 18, 1980. Paragraph (a)(5)(ii) of this section shall be effective for exchanges and elections occurring after June 6, 1988.

[T.D. 8198, 53 FR 16224, May 5, 1988; 53 FR 18022, May 19, 1988; T.D. 9082, 68 FR 46084, Aug. 5, 2003]

§ 1.897–7T Treatment of certain partnership interests as entirely U.S. real property interests under sections 897(g) and 1445(e) (temporary).

(a) *Rule.* Pursuant to section 897(g), an interest in a partnership in which, directly or indirectly, fifty percent or more of the value of the gross assets consist of U.S. real property interests, and ninety percent or more of the value of the gross assets consist of U.S. real property interests plus any cash or cash equivalents shall, for purposes of section 1445, be treated as entirely a U.S. real property interest. For purposes of section 897(g), such interest shall be treated as a U.S. real property interest only to the extent that the gain on the disposition is attributable to U.S. real property interests (and not cash, cash equivalents or other property). Consequently, a disposition of any portion of such partnership interest shall be subject to partial taxation under section 897(a) and full withholding under section 1445(a). For purposes of this paragraph, cash equivalent means any asset readily convertible into cash (whether or not denominated in U.S. dollars) including, but not limited to, bank accounts, certificates of deposit, money market accounts, commercial paper, U.S. and foreign treasury obligations and bonds, corporate obligations and bonds, precious metals or commodities, and publicly traded instruments.

(b) *Effective date.* Section 1.897–7T shall be effective for transfers, exchanges, distributions and other dispositions occurring after June 6, 1988.

[T.D. 8198, 53 FR 16228, May 5, 1988]

§ 1.897–8T Status as a U.S. real property holding corporation as a condition for electing section 897(i) pursuant to § 1.897–3 (temporary).

(a) *Purpose and scope.* This section provides a temporary regulation that if and when adopted as a final regulation, will be added to paragraph (b) of § 1.897–3. Paragraph (b) of this section would then appear as paragraph (b)(4) of § 1.897–3.

(b) *General conditions.* The foreign corporation upon making an election under section 897(i) (including any retroactive election) must qualify as a U.S. real property holding corporation as defined in paragraph (b)(1) of § 1.897–2.

(c) *Effective Date.* Section 1.897–8T shall be effective as of June 6, 1988, with respect to foreign corporations making an election under section 897(i) after May 5, 1988.

[T.D. 8198, 53 FR 16229, May 5, 1988]

§ 1.897–9T Treatment of certain interest in publicly traded corporations, definition of foreign person, and foreign governments and international organizations (temporary).

(a) *Purpose and scope.* This section provides a temporary regulation that, if and when adopted as a final regulation will be added as new paragraphs (c)(2)(iii)(B), (k), (n) and (q) of § 1.897–1. Paragraph (b) of this section would then appear as paragraph (c)(2)(iii)(B) of § 1.897–1. Paragraph (c) of this section would then appear as paragraph (k) of § 1.897–1. Paragraph (d) of this section would then appear as paragraph (n) of § 1.897–1. Paragraph (e) of this section would then appear as paragraph (q) of § 1.897–1.

(b) Any other interest in the corporation (other than an interest solely as a creditor) if on the date such interest was acquired by its present holder it had a fair market value greater than the fair market value on that date of 5 percent of the regularly traded class of the corporation's stock with the lowest fair market value. However, if a non-regularly traded class of interests in the corporation is convertible into a regularly traded class of interests in the corporation, an interest in such non-regularly traded class shall be treated as a U.S. real property interest

if on the date it was acquired by its present holder it had a fair market value greater than the fair market value on that date of 5 percent of the regularly traded class of the corporation's stock into which it is convertible. If a person holds interests in a corporation of a class that is not regularly traded, and subsequently acquires additional interests of the same class, then all such interests must be aggregated and valued as of the date of the subsequent acquisition. If the subsequent acquisition causes that person's interests to exceed the applicable limitation, then all such interests shall be treated as U.S. real property interests, regardless of when acquired. In addition, if a person holds interests in a corporation of separate classes that are not regularly traded, and if such interests were separately acquired for a principal purpose of avoiding the applicable 5 percent limitation of this paragraph, then such interests shall be aggregated for purposes of applying that limitation. This rule shall not apply to interests of separate classes acquired in transactions more than three years apart. For purposes of paragraph (c)(2)(iii) of § 1.897–1, section 318(a) shall apply (except that section 318(a)(2)(C) and (3)(C) shall each be applied by substituting ''5 percent'' for ''50 percent'').

(c) *Foreign person*. The term ''foreign person'' means a nonresident alien individual (including an individual subject to the provisions of section 877), a foreign corporation as defined in paragraph (1) of this section, a foreign partnership, a foreign trust or a foreign estate, as such persons are defined respectively by § 1.871–2 and by 7701 and the regulations thereunder. A resident alien individual, including a nonresident alien with respect to whom there is in effect an election under section 6013(g) or (h) to be treated as United States resident, is not a foreign person. With respect to the status of foreign governments and international organizations, see paragraph (e) of this section.

(d) *Regularly traded*—(1) *General rule*—(i) *Trading requirements*. A class of interests that is traded on one or more established securities markets is considered to be regularly traded on such market or markets for any calendar quarter during which—

(A) Trades in such class are effected, other than in *de minimis* quantities, on at least 15 days during the calendar quarter;

(B) The aggregate number of the interests in such class traded is at least 7.5 percent or more of the average number of interests in such class outstanding during the calendar quarter; and

(C) The requirements of paragraph (d)(3) of this section are met.

(ii) *Exceptions*—(A) in the case of the class of interests which is held by 2,500 or more record shareholders, the requirements of paragraph (d)(1)(i)(B) of this section shall be applied by substituting ''2.5 percent'' for ''7.5 percent''.

(B) If at any time during the calendar quarter 100 or fewer persons own 50 percent or more of the outstanding shares of a class of interests, such class shall not be considered to be regularly traded for purposes of sections 897, 1445 and 6039C. Related persons shall be treated as one person for purposes of this paragraph (d)(1)(ii)(B).

(iii) *Anti-abuse rule*. Trades between related persons shall be disregarded. In addition, a class of interests shall not be treated as regularly traded if there is an arrangement or a pattern of trades designed to meet the requirements of this paragraph (d)(1). For example, trades between two persons that occur several times during the calendar quarter may be treated as an arrangement or a pattern of trades designed to meet the requirements of this paragraph (d)(1).

(2) *Interests traded on domestic established securities markets*. For purposes of sections 897, 1445 and 6039C, a class of interests that is traded on an established securities market located in the United States is considered to be regularly traded for any calendar quarter during which it is regularly quoted by brokers or dealers making a market in such interests. A broker or dealer makes a market in a class of interests only if the broker or dealer holds himself out to buy or sell interests in such class at the quoted price. Stock of a corporation that is described in section 851(a)(1) and units of a unit investment

trust registered under the Investment Company Act of 1940 (15 U.S.C. sections 80a–1 to 80a–2) shall be treated as regularly traded within the meaning of this paragraph.

(3) *Reporting requirement for interests traded on foreign securities markets.* A class of interests in a domestic corporation that is traded on one or more established securities markets located outside the United States shall not be considered to be regularly traded on such market or markets unless such class is traded in registered form, and—

(i) The corporation registers such class of interests pursuant to section 12 of the Securities Exchange Act of 1934, 15 U.S.C. section 78, or

(ii) The corporation attaches to its Federal income tax return a statement providing the following:

(A) A caption which states ''The following information concerning certain shareholders of this corporation is provided in accordance with the requirements of § 1.897–9T.''

(B) The name under which the corporation is incorporated, the state in which such corporation is incorporated, the principal place of business of the corporation, and its employer identification number, if any;

(C) The identity of each person who, at any time during the corporation's taxable year, was the beneficial owner of more than 5 percent of any class of interests of the corporation to which this paragraph (d)(3) applies;

(D) The title, and the total number of shares issued, of any class of interests so owned; and

(E) With respect to each beneficial owner of more than 5 percent of any class of interests of the corporation, the number of shares owned, the percentage of the class represented thereby, and the nature of the beneficial ownership of each class of shares so owned.

Interests in a domestic corporation which has filed a report pursuant to this paragraph (d)(3)(ii) shall be considered to be regularly traded on an established securities market only for the taxable year of the corporation with respect to which such a report is filed.

(4) *Coordination with section 1445.* For purposes of section 1445, a class of interests in a corporation shall be presumed to be regularly traded during a calendar quarter if such interests were regularly traded within the meaning of this paragraph during the previous calendar quarter.

(e) *Foreign governments and international organizations.* A foreign government shall be treated as a foreign person with respect to U.S. real property interests, and shall be subject to sections 897, 1445, and 6039C on the disposition of a U.S. real property interest except to the extent specifically otherwise provided in the regulations issued under section 892. An international organization (as defined in section 7701(a)(18)) is not a foreign person with respect to U.S. real property interests, and is not subject to sections 897, 1445, and 6039C on the disposition of a U.S. real property interest. Buildings or parts of buildings and the land ancillary thereto (including the residence of the head of the diplomatic mission) used by the foreign government for a diplomatic mission shall not be a U.S. real property interest in the hands of the respective foreign government.

(f) *Effective date.* Section 1.897–9T with the exception of paragraph (e) shall be effective for transfers, exchanges, distributions and other dispositions occurring on or after June 6, 1988. Paragraph (e) of this section shall be effective for transfers, exchanges, distributions and other dispositions occurring on or after July 1, 1986.

[T.D. 8198, 53 FR 16229, May 5, 1988]

INCOME FROM SOURCES WITHOUT THE UNITED STATES

FOREIGN TAX CREDIT

§ 1.901–1 Allowance of credit for taxes.

(a) *In general.* Citizens of the United States, domestic corporations, and certain aliens resident in the United States or Puerto Rico may choose to claim a credit, as provided in section 901, against the tax imposed by chapter 1 of the Internal Revenue Code (Code) for taxes paid or accrued to foreign countries and possessions of the United States, subject to the conditions prescribed in paragraphs (a)(1) through (a)(3) and paragraph (b) of this section.

(1) *Citizen of the United States.* A citizen of the United States, whether resident or nonresident, may claim a credit for—

(i) The amount of any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country or to any possession of the United States; and

(ii) His share of any such taxes of a partnership of which he is a member, or of an estate or trust of which he is a beneficiary.

(2) *Domestic corporation.* A domestic corporation may claim a credit for—

(i) The amount of any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country or to any possession of the United States;

(ii) Its share of any such taxes of a partnership of which it is a member, or of an estate or trust of which it is a beneficiary; and

(iii) The taxes deemed to have been paid under section 902 or 960.

(3) *Alien resident of the United States or Puerto Rico.* Except as provided in a Presidential proclamation described in section 901(c), an alien resident of the United States, or an alien individual who is a bona fide resident of Puerto Rico during the entire taxable year, may claim a credit for—

(i) The amount of any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country or to any possession of the United States; and

(ii) His distributive share of any such taxes of a partnership of which he is a member, or of an estate or trust of which he is a beneficiary.

(b) *Limitations.* Certain Code sections, including sections 814, 901(e) through (m), 904, 906, 907, 908, 909, 911, 999, and 6038, limit the credit against the tax imposed by chapter 1 of the Code for certain foreign taxes.

(c) *Deduction denied if credit claimed.* If a taxpayer chooses with respect to any taxable year to claim a credit for taxes to any extent, such choice will be considered to apply to income, war profits, and excess profits taxes paid or accrued in such taxable year to all foreign countries and possessions of the United States, and no portion of any such taxes shall be allowed as a deduction from gross income in such taxable year or any succeeding taxable year. See section 275(a)(4).

(d) *Period during which election can be made or changed.* The taxpayer may, for a particular taxable year, claim the benefits of section 901 (or claim a deduction in lieu of a foreign tax credit) at any time before the expiration of the period prescribed by section 6511(d)(3)(A) (or section 6511(c) if the period is extended by agreement).

(e) *Joint return.* In the case of a husband and wife making a joint return, credit for taxes paid or accrued to any foreign country or to any possession of the United States shall be computed upon the basis of the total taxes so paid by or accrued against the spouses.

(f) *Taxes against which credit not allowed*— The credit for taxes shall be allowed only against the tax imposed by chapter 1 of the Code, but it shall not be allowed against the following taxes imposed under that chapter:

(1) The minimum tax for tax preferences imposed by section 56;

(2) The 10 percent tax on premature distributions to owner-employees imposed by section 72(m)(5)(B);

(3) The tax on lump sum distributions imposed by section 402(e);

(4) The additional tax on income from certain retirement accounts imposed by section 408(f);

(5) The tax on accumulated earnings imposed by section 531;

(6) The personal holding company tax imposed by section 541;

(7) The additional tax relating to war loss recoveries imposed by section 1333; and

(8) The additional tax relating to recoveries of foreign expropriation losses imposed by section 1351.

(g) *Taxpayers to whom credit not allowed.* Among those to whom the credit for taxes is not allowed are the following:

(1) Except as provided in section 906, a foreign corporation.

(2) Except as provided in section 906, a nonresident alien individual who is not described in section 876 (see sections 874(c) and 901(b)(4)).

(3) A nonresident alien individual described in section 876 other than a bona fide resident (as defined in section 937(a) and the regulations under that

section) of Puerto Rico during the entire taxable year (see sections 901(b)(3) and (4)).

(4) A U.S. citizen or resident alien individual who is a bona fide resident of a section 931 possession (as defined in § 1.931–1(c)(1)), the U.S. Virgin Islands, or Puerto Rico, and who excludes certain income from U.S. gross income to the extent of taxes allocable to the income so excluded (see sections 931(b)(2), 933(1), and 932(c)(4)).

(h) *Taxpayers denied credit in a particular taxable year.* Taxpayers who are denied the credit for taxes for particular taxable years are the following:

(1) An individual who elects to pay the optional tax imposed by section 3, or one who elects under section 144 to take the standard deduction (see section 36);

(2) A taxpayer who elects to deduct taxes paid or accrued to any foreign country or possession of the United States (see sections 164 and 275);

(3) A regulated investment company which has exercised the election under section 853.

(i) *Dividends from a DISC treated as foreign.* For purposes of sections 901 through 906 and the regulations thereunder, any amount treated as a dividend from a corporation which is a DISC or former DISC (as defined in section 992(a) (1) or (3) as the case may be) will be treated as a dividend from a foreign corporation to the extent such dividend is treated under section 861(a)(2)(D) as income from sources without the United States.

(j) *Effective/applicability date.* Paragraph (g) of this section applies to taxable years ending after April 9, 2008. Paragraphs (a) and (b) of this section apply to taxable years ending after July 13, 2011.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960]

EDITORIAL NOTE: For FEDERAL REGISTER citations affecting § 1.901–1, see the List of CFR Sections Affected, which appears in the Finding Aids section of the printed volume and at *www.fdsys.gov*.

§ 1.901–2 Income, war profits, or excess profits tax paid or accrued.

(a) *Definition of income, war profits, or excess profits tax*—(1) *In general.* Section 901 allows a credit for the amount of income, war profits or excess profits tax (referred to as ''income tax'' for purposes of this section and §§ 1.901–2A and 1.903–1) paid to any foreign country. Whether a foreign levy is an income tax is determined independently for each separate foreign levy. A foreign levy is an income tax if and only if—

(i) It is a tax; and

(ii) The predominant character of that tax is that of an income tax in the U.S. sense.

Except to the extent otherwise provided in paragraphs (a)(3)(ii) and (c) of this section, a tax either is or is not an income tax, in its entirety, for all persons subject to the tax. Paragraphs (a), (b) and (c) of this section define an income tax for purposes of section 901. Paragraph (d) of this section contains rules describing what constitutes a separate foreign levy. Paragraph (e) of this section contains rules for determining the amount of tax paid by a person. Paragraph (f) of this section contains rules for determining by whom foreign tax is paid. Paragraph (g) of this section contains definitions of the terms ''paid by,'' ''foreign country,'' and ''foreign levy.'' Paragraph (h) of this section states the effective date of this section.

(2) *Tax*—(i) *In general.* A foreign levy is a tax if it requires a compulsory payment pursuant to the authority of a foreign country to levy taxes. A penalty, fine, interest, or similar obligation is not a tax, nor is a customs duty a tax. Whether a foreign levy requires a compulsory payment pursuant to a foreign country's authority to levy taxes is determined by principles of U.S. law and not by principles of law of the foreign country. Therefore, the assertion by a foreign country that a levy is pursuant to the foreign country's authority to levy taxes is not determinative that, under U.S. principles, it is pursuant thereto. Notwithstanding any assertion of a foreign country to the contrary, a foreign levy is not pursuant to a foreign country's authority to levy taxes, and thus is not a tax, to the extent a person subject to the levy receives (or will receive), directly or indirectly, a specific economic benefit (as defined in paragraph (a)(2)(ii)(B) of this section) from the

foreign country in exchange for payment pursuant to the levy. Rather, to that extent, such levy requires a compulsory payment in exchange for such specific economic benefit. If, applying U.S. principles, a foreign levy requires a compulsory payment pursuant to the authority of a foreign country to levy taxes and also requires a compulsory payment in exchange for a specific economic benefit, the levy is considered to have two distinct elements: A tax and a requirement of compulsory payment in exchange for such specific economic benefit. In such a situation, these two distinct elements of the foreign levy (and the amount paid pursuant to each such element) must be separated. No credit is allowable for a payment pursuant to a foreign levy by a dual capacity taxpayer (as defined in paragraph (a)(2)(ii)(A) of this section) unless the person claiming such credit establishes the amount that is paid pursuant to the distinct element of the foreign levy that is a tax. See paragraph (a)(2)(ii) of this section and § 1.901–2A.

(ii) *Dual capacity taxpayers*—(A) *In general.* For purposes of this section and §§ 1.901–2A and 1.903–1, a person who is subject to a levy of a foreign state or of a possession of the United States or of a political subdivision of such a state or possession and who also, directly or indirectly (within the meaning of paragraph (a)(2)(ii)(E) of this section) receives (or will receive) a specific economic benefit from the state or possession or from a political subdivision of such state or possession or from an agency or instrumentality of any of the foregoing is referred to as a ''dual capacity taxpayer.'' Dual capacity taxpayers are subject to the special rules of § 1.901–2A.

(B) *Specific economic benefit.* For purposes of this section and §§ 1.901–2A and 1.903–1, the term ''specific economic benefit'' means an economic benefit that is not made available on substantially the same terms to substantially all persons who are subject to the income tax that is generally imposed by the foreign country, or, if there is no such generally imposed income tax, an economic benefit that is not made available on substantially the same terms to the population of the country in general. Thus, a concession to extract government-owned petroleum is a specific economic benefit, but the right to travel or to ship freight on a government-owned airline is not, because the latter, but not the former, is made generally available on substantially the same terms. An economic benefit includes property; a service; a fee or other payment; a right to use, acquire or extract resources, patents or other property that a foreign country owns or controls (within the meaning of paragraph (a)(2)(ii)(D) of this section); or a reduction or discharge of a contractual obligation. It does not include the right or privilege merely to engage in business generally or to engage in business in a particular form.

(C) *Pension, unemployment, and disability fund payments.* A foreign levy imposed on individuals to finance retirement, old-age, death, survivor, unemployment, illness, or disability benefits, or for some substantially similar purpose, is not a requirement of compulsory payment in exchange for a specific economic benefit, as long as the amounts required to be paid by the individuals subject to the levy are not computed on a basis reflecting the respective ages, life expectancies or similar characteristics of such individuals.

(D) *Control of property.* A foreign country controls property that it does not own if the country exhibits substantial indicia of ownership with respect to the property, for example, by both regulating the quantity of property that may be extracted and establishing the minimum price at which it may be disposed of.

(E) *Indirect receipt of a benefit.* A person is considered to receive a specific economic benefit indirectly if another person receives a specific economic benefit and that other person—

(*1*) Owns or controls, directly or indirectly, the first person or is owned or controlled, directly or indirectly, by the first person or by the same persons that own or control, directly or indirectly, the first person; or

(*2*) Engages in a transaction with the first person under terms and conditions such that the first person receives, directly or indirectly, all or part of the value of the specific economic benefit.

(3) *Predominant character.* The predominant character of a foreign tax is

that of an income tax in the U.S. sense—

(i) If, within the meaning of paragraph (b)(1) of this section, the foreign tax is likely to reach net gain in the normal circumstances in which it applies,

(ii) But only to the extent that liability for the tax is not dependent, within the meaning of paragraph (c) of this section, by its terms or otherwise, on the availability of a credit for the tax against income tax liability to another country.

(b) *Net gain*—(1) *In general.* A foreign tax is likely to reach net gain in the normal circumstances in which it applies if and only if the tax, judged on the basis of its predominant character, satisfies each of the realization, gross receipts, and net income requirements set forth in paragraphs (b)(2), (b)(3) and (b)(4), respectively, of this section.

(2) *Realization*—(i) *In general.* A foreign tax satisfies the realization requirement if, judged on the basis of its predominant character, it is imposed—

(A) Upon or subsequent to the occurrence of events (''realization events'') that would result in the realization of income under the income tax provisions of the Internal Revenue Code;

(B) Upon the occurrence of an event prior to a realization event (a ''prerealization event'') provided the consequence of such event is the recapture (in whole or part) of a tax deduction, tax credit or other tax allowance previously accorded to the taxpayer; or

(C) Upon the occurrence of a prerealization event, other than one described in paragraph (b)(2)(i)(B) of this section, but only if the foreign country does not, upon the occurrence of a later event (other than a distribution or a deemed distribution of the income), impose tax (''second tax'') with respect to the income on which tax is imposed by reason of such prerealization event (or, if it does impose a second tax, a credit or other comparable relief is available against the liability for such a second tax for tax paid on the occurrence of the prerealization event) and—

(*1*) The imposition of the tax upon such prerealization event is based on the difference in the values of property at the beginning and end of a period; or

(*2*) The prerealization event is the physical transfer, processing, or export of readily marketable property (as defined in paragraph (b)(2)(iii) of this section).

A foreign tax that, judged on the basis of its predominant character, is imposed upon the occurrence of events described in this paragraph (b)(2)(i) satisfies the realization requirement even if it is also imposed in some situations upon the occurrence of events not described in this paragraph (b)(2)(i). For example, a foreign tax that, judged on the basis of its predominant character, is imposed upon the occurrence of events described in this paragraph (b)(2)(i) satisfies the realization requirement even though the base of that tax also includes imputed rental income from a personal residence used by the owner and receipt of stock dividends of a type described in section 305(a) of the Internal Revenue Code. As provided in paragraph (a)(1) of this section, a tax either is or is not an income tax, in its entirety, for all persons subject to the tax; therefore, a foreign tax described in the immediately preceding sentence satisfies the realization requirement even though some persons subject to the tax will on some occasions not be subject to the tax except with respect to such imputed rental income and such stock dividends. However, a foreign tax based only or predominantly on such imputed rental income or only or predominantly on receipt of such stock dividends does not satisfy the realization requirement.

(ii) *Certain deemed distributions.* A foreign tax that does not satisfy the realization requirement under paragraph (b)(2)(i) of this section is nevertheless considered to meet the realization requirement if it is imposed with respect to a deemed distribution (*e.g.*, by a corporation to a shareholder) of amounts that meet the realization requirement in the hands of the person that, under foreign law, is deemed to distribute such amount, but only if the foreign country does not, upon the occurrence of a later event (*e.g.*, an actual distribution), impose tax (''second tax'') with respect to the income on which tax was imposed by reason of such deemed distribution (or, if it does impose a second tax, a credit or other

comparable relief is available against the liability for such a second tax for tax paid with respect to the deemed distribution).

(iii) *Readily marketable property*. Property is readily marketable if—

(A) It is stock in trade or other property of a kind that properly would be included in inventory if on hand at the close of the taxable year or if it is held primarily for sale to customers in the ordinary course of business, and

(B) It can be sold on the open market without further processing or it is exported from the foreign country.

(iv) *Examples*. The provisions of paragraph (b)(2) of this section may be illustrated by the following examples:

Example 1. Residents of country X are subject to a tax of 10 percent on the aggregate net appreciation in fair market value during the calendar year of all shares of stock held by them at the end of the year. In addition, all such residents are subject to a country X tax that qualifies as an income tax within the meaning of paragraph (a)(1) of this section. Included in the base of the income tax are gains and losses realized on the sale of stock, and the basis of stock for purposes of determining such gain or loss is its cost. The operation of the stock appreciation tax and the income tax as applied to sales of stock is exemplified as follows: *A*, a resident of country X, purchases stock in June, 1983 for 100u (units of country X currency) and sells it in May, 1985 for 160u. On December 31, 1983, the stock is worth 120u and on December 31, 1984, it is worth 155u. Pursuant to the stock appreciation tax, *A* pays 2u for 1983 (10 percent of (120u − 100u)), 3.5u for 1984 (10 percent of (155u − 120u)), and nothing in 1985 because no stock was held at the end of that year. For purposes of the income tax, *A* must include 60u (160u − 100u) in his income for 1985, the year of sale. Pursuant to paragraph (b)(2)(i)(C) of this section, the stock appreciation tax does not satisfy the realization requirement because country X imposes a second tax upon the occurrence of a later event (*i.e.*, the sale of stock) with respect to the income that was taxed by the stock appreciation tax and no credit or comparable relief is available against such second tax for the stock appreciation tax paid.

Example 2. The facts are the same as in example 1 except that if stock was held on the December 31 last preceding the date of its sale, the basis of such stock for purposes of computing gain or loss under the income tax is the value of the stock on such December 31. Thus, in 1985, *A* includes only 5u (160u—155u) as income from the sale for purposes of the income tax. Because the income tax imposed upon the occurrence of a later event (the sale) does not impose a tax with respect to the income that was taxed by the stock appreciation tax, the stock appreciation tax satisfies the realization requirement. The result would be the same if, instead of a basis adjustment to reflect taxation pursuant to the stock appreciation tax, the country X income tax allowed a credit (or other comparable relief) to take account of the stock appreciation tax. If a credit mechanism is used, see also paragraph (e)(4)(i) of this section.

Example 3. Country X imposes a tax on the realized net income of corporations that do business in country X. Country X also imposes a branch profits tax on corporations organized under the law of a country other than country X that do business in country X. The branch profits tax is imposed when realized net income is remitted or deemed to be remitted by branches in country X to home offices outside of country X. The branch profits tax is imposed subsequent to the occurrence of events that would result in realization of income (*i.e.*, by corporations subject to such tax) under the income tax provisions of the Internal Revenue Code; thus, in accordance with paragraph (b)(2)(i)(A) of this section, the branch profits tax satisfies the realization requirement.

Example 4. Country X imposes a tax on the realized net income of corporations that do business in country X (the ''country X corporate tax''). Country X also imposes a separate tax on shareholders of such corporations (the ''country X shareholder tax''). The country X shareholder tax is imposed on the sum of the actual distributions received during the taxable year by such a shareholder from the corporation's realized net income for that year (*i.e.*, income from past years is not taxed in a later year when it is actually distributed) plus the distributions deemed to be received by such a shareholder. Deemed distributions are defined as (A) a shareholder's pro rata share of the corporation's realized net income for the taxable year, less (B) such shareholder's pro rata share of the corporation's country X corporate tax for that year, less (C) actual distributions made by such corporation to such shareholder from such net income. A shareholder's receipt of actual distributions is a realization event within the meaning of paragraph (b)(2)(i)(A) of this section. The deemed distributions are not realization events, but they are described in paragraph (b)(2)(ii) of this section. Accordingly, the country X shareholder tax satisfies the realization requirement.

(3) *Gross receipts*—(i) *In general*. A foreign tax satisfies the gross receipts requirement if, judged on the basis of its predominant character, it is imposed on the basis of—

(A) Gross receipts; or

(B) Gross receipts computed under a method that is likely to produce an amount that is not greater than fair market value.

A foreign tax that, judged on the basis of its predominant character, is imposed on the basis of amounts described in this paragraph (b)(3)(i) satisfies the gross receipts requirement even if it is also imposed on the basis of some amounts not described in this paragraph (b)(3)(i).

(ii) *Examples*. The provisions of paragraph (b)(3)(i) of this section may be illustrated by the following examples:

Example 1. Country X imposes a ''headquarters company tax'' on country X corporations that serve as regional headquarters for affiliated nonresident corporations, and this tax is a separate tax within the meaning of paragraph (d) of this section. A headquarters company for purposes of this tax is a corporation that performs administrative, management or coordination functions solely for nonresident affiliated entities. Due to the difficulty of determining on a case-by-case basis the arm's length gross receipts that headquarters companies would charge affiliates for such services, gross receipts of a headquarters company are deemed, for purposes of this tax, to equal 110 percent of the business expenses incurred by the headquarters company. It is established that this formula is likely to produce an amount that is not greater than the fair market value of arm's length gross receipts from such transactions with affiliates. Pursuant to paragraph (b)(3)(i)(B) of this section, the headquarters company tax satisfies the gross receipts requirement.

Example 2. The facts are the same as in Example 1, with the added fact that in the case of a particular taxpayer, *A*, the formula actually produces an amount that is substantially greater than the fair market value of arm's length gross receipts from transactions with affiliates. As provided in paragraph (a)(1) of this section, the headquarters company tax either is or is not an income tax, in its entirety, for all persons subject to the tax. Accordingly, the result is the same as in example 1 for all persons subject to the headquarters company tax, including *A*.

Example 3. Country X imposes a separate tax (within the meaning of paragraph (d) of this section) on income from the extraction of petroleum. Under that tax, gross receipts from extraction income are deemed to equal 105 percent of the fair market value of petroleum extracted. This computation is designed to produce an amount that is greater than the fair market value of actual gross receipts; therefore, the tax on extraction income is not likely to produce an amount that is not greater than fair market value. Accordingly, the tax on extraction income does not satisfy the gross receipts requirement. However, if the tax satisfies the criteria of § 1.903–1(a), it is a tax in lieu of an income tax.

(4) *Net income*—(i) *In general*. A foreign tax satisfies the net income requirement if, judged on the basis of its predominant character, the base of the tax is computed by reducing gross receipts (including gross receipts as computed under paragraph (b)(3)(i)(B) of this section) to permit—

(A) Recovery of the significant costs and expenses (including significant capital expenditures) attributable, under reasonable principles, to such gross receipts; or

(B) Recovery of such significant costs and expenses computed under a method that is likely to produce an amount that approximates, or is greater than, recovery of such significant costs and expenses.

A foreign tax law permits recovery of significant costs and expenses even if such costs and expenses are recovered at a different time than they would be if the Internal Revenue Code applied, unless the time of recovery is such that under the circumstances there is effectively a denial of such recovery. For example, unless the time of recovery is such that under the circumstances there is effectively a denial of such recovery, the net income requirement is satisfied where items deductible under the Internal Revenue Code are capitalized under the foreign tax system and recovered either on a recurring basis over time or upon the occurrence of some future event or where the recovery of items capitalized under the Internal Revenue Code occurs less rapidly under the foreign tax system. A foreign tax law that does not permit recovery of one or more significant costs or expenses, but that provides allowances that effectively compensate for nonrecovery of such significant costs or expenses, is considered to permit recovery of such costs or expenses. Principles used in the foreign tax law to attribute costs and expenses to gross receipts may be reasonable even if they differ from principles that apply under

the Internal Revenue Code (e.g., principles that apply under section 265, 465 or 861(b) of the Internal Revenue Code). A foreign tax whose base, judged on the basis of its predominant character, is computed by reducing gross receipts by items described in paragraph (b)(4)(i)(A) or (B) of this section satisfies the net income requirement even if gross receipts are not reduced by some such items. A foreign tax whose base is gross receipts or gross income does not satisfy the net income requirement except in the rare situation where that tax is almost certain to reach some net gain in the normal circumstances in which it applies because costs and expenses will almost never be so high as to offset gross receipts or gross income, respectively, and the rate of the tax is such that after the tax is paid persons subject to the tax are almost certain to have net gain. Thus, a tax on the gross receipts or gross income of businesses can satisfy the net income requirement only if businesses subject to the tax are almost certain never to incur a loss (after payment of the tax). In determining whether a foreign tax satisfies the net income requirement, it is immaterial whether gross receipts are reduced, in the base of the tax, by another tax, provided that other tax satisfies the realization, gross receipts and net income requirements.

(ii) *Consolidation of profits and losses.* In determining whether a foreign tax satisfies the net income requirement, one of the factors to be taken into account is whether, in computing the base of the tax, a loss incurred in one activity (e.g., a contract area in the case of oil and gas exploration) in a trade or business is allowed to offset profit earned by the same person in another activity (e.g., a separate contract area) in the same trade or business. If such an offset is allowed, it is immaterial whether the offset may be made in the taxable period in which the loss is incurred or only in a different taxable period, unless the period is such that under the circumstances there is effectively a denial of the ability to offset the loss against profit. In determining whether a foreign tax satisfies the net income requirement, it is immaterial that no such offset is allowed if a loss incurred in one such activity may be applied to offset profit earned in that activity in a different taxable period, unless the period is such that under the circumstances there is effectively a denial of the ability to offset such loss against profit. In determining whether a foreign tax satisfies the net income requirement, it is immaterial whether a person's profits and losses from one trade or business (*e.g.*, oil and gas extraction) are allowed to offset its profits and losses from another trade or business (*e. g.*, oil and gas refining and processing), or whether a person's business profits and losses and its passive investment profits and losses are allowed to offset each other in computing the base of the foreign tax. Moreover, it is immaterial whether foreign law permits or prohibits consolidation of profits and losses of related persons, unless foreign law requires separate entities to be used to carry on separate activities in the same trade or business. If foreign law requires that separate entities carry on such separate activities, the determination whether the net income requirement is satisfied is made by applying the same considerations as if such separate activities were carried on by a single entity.

(iii) *Carryovers.* In determining whether a foreign tax satisfies the net income requirement, it is immaterial, except as otherwise provided in paragraph (b)(4)(ii) of this section, whether losses incurred during one taxable period may be carried over to offset profits incurred in different taxable periods.

(iv) *Examples.* The provisions of this paragraph (b)(4) may be illustrated by the following examples:

Example 1. Country X imposes an income tax on corporations engaged in business in country X; however, that income tax is not applicable to banks. Country X also imposes a tax (the ''bank tax'') of 1 percent on the gross amount of interest income derived by banks from branches in country X; no deductions are allowed. Banks doing business in country X incur very substantial costs and expenses (e.g., interest expense) attributable to their interest income. The bank tax neither provides for recovery of significant costs and expenses nor provides any allowance that significantly compensates for the lack of such recovery. Since such banks are not almost certain never to incur a loss on

their interest income from branches in country X, the bank tax does not satisfy the net income requirement. However, if the tax on corporations is generally imposed, the bank tax satisfies the criteria of §1.903–1(a) and therefore is a tax in lieu of an income tax.

Example 2. Country X law imposes an income tax on persons engaged in business in country X. The base of that tax is realized net income attributable under reasonable principles to such business. Under the tax law of country X, a bank is not considered to be engaged in business in country X unless it has a branch in country X and interest income earned by a bank from a loan to a resident of country X is not considered attributable to business conducted by the bank in country X unless a branch of the bank in country X performs certain significant enumerated activities, such as negotiating the loan. Country X also imposes a tax (the ''bank tax'') of 1 percent on the gross amount of interest income earned by banks from loans to residents of country X if such banks do not engage in business in country X or if such interest income is not considered attributable to business conducted in country X. For the same reasons as are set forth in example 1, the bank tax does not satisfy the net income requirement. However, if the tax on persons engaged in business in country X is generally imposed, the bank tax satisfies the criteria of §1.903–1(a) and therefore is a tax in lieu of an income tax.

Example 3. A foreign tax is imposed at the rate of 40 percent on the amount of gross wages realized by an employee; no deductions are allowed. Thus, the tax law neither provides for recovery of costs and expenses nor provides any allowance that effectively compensates for the lack of such recovery. Because costs and expenses of employees attributable to wage income are almost always insignificant compared to the gross wages realized, such costs and expenses will almost always not be so high as to offset the gross wages and the rate of the tax is such that, under the circumstances, after the tax is paid, employees subject to the tax are almost certain to have net gain.

Accordingly, the tax satisfies the net income requirement.

Example 4. Country X imposes a tax at the rate of 48 percent of the ''taxable income'' of nonresidents of country X who furnish specified types of services to customers who are residents of country X. ''Taxable income'' for purposes of the tax is defined as gross receipts received from residents of country X (regardless of whether the services to which the receipts relate are performed within or outside country X) less deductions that permit recovery of the significant costs and expenses (including significant capital expenditures) attributable under reasonable principles to such gross receipts. The country X tax satisfies the net income requirement.

Example 5. Each of country X and province Y (a political subdivision of country X) imposes a tax on corporations, called the ''country X income tax'' and the ''province Y income tax,'' respectively. Each tax has an identical base, which is computed by reducing a corporation's gross receipts by deductions that, based on the predominant character of the tax, permit recovery of the significant costs and expenses (including significant capital expenditures) attributable under reasonable principles to such gross receipts. The country X income tax does not allow a deduction for the province Y income tax for which a taxpayer is liable, nor does the province Y income tax allow a deduction for the country X income tax for which a taxpayer is liable. As provided in paragraph (d)(1) of this section, each of the country X income tax and the province Y income tax is a separate levy. Both of these levies satisfy the net income requirement; the fact that neither levy's base allows a deduction for the other levy is immaterial in reaching that determination.

(c) *Soak-up taxes*—(1) *In general.* Pursuant to paragraph (a)(3)(ii) of this section, the predominant character of a foreign tax that satisfies the requirement of paragraph (a)(3)(i) of this section is that of an income tax in the U.S. sense only to the extent that liability for the foreign tax is not dependent (by its terms or otherwise) on the availability of a credit for the tax against income tax liability to another country. Liability for foreign tax is dependent on the availability of a credit for the foreign tax against income tax liability to another country only if and to the extent that the foreign tax would not be imposed on the taxpayer but for the availability of such a credit. See also §1.903–1(b)(2).

(2) *Examples.* The provisions of paragraph (c)(1) of this section may be illustrated by the following examples:

Example 1. Country X imposes a tax on the receipt of royalties from sources in country X by nonresidents of country X. The tax is 15 percent of the gross amount of such royalties unless the recipient is a resident of the United States or of country A, B, C, or D, in which case the tax is 20 percent of the gross amount of such royalties. Like the United States, each of countries A, B, C, and D allows its residents a credit against the income tax otherwise payable to it for income taxes paid to other countries. Because the 20 percent rate applies only to residents of countries which allow a credit for taxes paid

to other countries and the 15 percent rate applies to residents of countries which do not allow such a credit, one-fourth of the country X tax would not be imposed on residents of the United States but for the availability of such a credit. Accordingly, one-fourth of the country X tax imposed on residents of the United States who receive royalties from sources in country X is dependent on the availability of a credit for the country X tax against income tax liability to another country.

Example 2. Country X imposes a tax on the realized net income derived by all nonresidents from carrying on a trade or business in country X. Although country X law does not prohibit other nonresidents from carrying on business in country X, United States persons are the only nonresidents of country X that carry on business in country X in 1984. The country X tax would be imposed in its entirety on a nonresident of country X irrespective of the availability of a credit for country X tax against income tax liability to another country. Accordingly, no portion of that tax is dependent on the availability of such a credit.

Example 3. Country X imposes tax on the realized net income of all corporations incorporated in country X. Country X allows a tax holiday to qualifying corporations incorporated in country X that are owned by nonresidents of country X, pursuant to which no country X tax is imposed on the net income of a qualifying corporation for the first ten years of its operations in country X. A corporation qualifies for the tax holiday if it meets certain minimum investment criteria and if the development office of country X certifies that in its opinion the operations of the corporation will be consistent with specified development goals of country X. The development office will not so certify to any corporation owned by persons resident in countries that allow a credit (such as that available under section 902 of the Internal Revenue Code) for country X tax paid by a corporation incorporated in country X. In practice, tax holidays are granted to a large number of corporations, but country X tax is imposed on a significant number of other corporations incorporated in country X (*e.g.*, those owned by country X persons and those which have had operations for more than 10 years) in addition to corporations denied a tax holiday because their shareholders qualify for a credit for the country X tax against income tax liability to another country. In the case of corporations denied a tax holiday because they have U.S. shareholders, no portion of the country X tax during the period of the denied 10-year tax holiday is dependent on the availability of a credit for the country X tax against income tax liability to another country.

Example 4. The facts are the same as in example 3, except that corporations owned by persons resident in countries that will allow a credit for country X tax at the time when dividends are distributed by the corporations are granted a provisional tax holiday. Under the provisional tax holiday, instead of relieving such a corporation from country X tax for 10 years, liability for such tax is deferred until the corporation distributes dividends. The result is the same as in example 3.

(d) *Separate levies*—(1) *In general.* For purposes of sections 901 and 903, whether a single levy or separate levies are imposed by a foreign country depends on U.S. principles and not on whether foreign law imposes the levy or levies in a single or separate statutes. A levy imposed by one taxing authority (*e.g.*, the national government of a foreign country) is always separate for purposes of sections 901 and 903 from a levy imposed by another taxing authority (*e.g.*, a political subdivision of that foreign country). Levies are not separate merely because different rates apply to different taxpayers. For example, a foreign levy identical to the tax imposed on U.S. citizens and resident alien individuals by section 1 of the Internal Revenue Code is a single levy notwithstanding the levy has graduated rates and applies different rate schedules to unmarried individuals, married individuals who file separate returns and married individuals who file joint returns. In general, levies are not separate merely because some provisions determining the base of the levy apply, by their terms or in practice, to some, but not all, persons subject to the levy. For example, a foreign levy identical to the tax imposed by section 11 of the Internal Revenue Code is a single levy even though some provisions apply by their terms to some but not all corporations subject to the section 11 tax (*e.g.*, section 465 is by its terms applicable to corporations described in sections 465(a)(1)(B) and 465(a)(1)(C), but not to other corporations), and even though some provisions apply in practice to some but not all corporations subject to the section 11 tax (*e.g.*, section 611 does not, in practice, apply to any corporation that does not have a qualifying interest in the type of property described in section 611(a)). However, where the base of a levy is different in kind, and not merely in degree, for different classes of persons subject to the levy, the levy

is considered for purposes of sections 901 and 903 to impose separate levies for such classes of persons. For example, regardless of whether they are contained in a single or separate foreign statutes, a foreign levy identical to the tax imposed by section 871(b) of the Internal Revenue Code is a separate levy from a foreign levy identical to the tax imposed by section 1 of the Internal Revenue Code as it applies to persons other than those described in section 871(b), and foreign levies identical to the taxes imposed by sections 11, 541, 881, 882, 1491 and 3111 of the Internal Revenue Code are each separate levies, because the base of each of those levies differs in kind, and not merely in degree, from the base of each of the others. Accordingly, each such levy must be analyzed separately to determine whether it is an income tax within the meaning of paragraph (a)(1) of this section and whether it is a tax in lieu of an income tax within the meaning of paragraph (a) of §1.903–1. Where foreign law imposes a levy that is the sum of two or more separately computed amounts, and each such amount is computed by reference to a separate base, separate levies are considered, for purposes of sections 901 and 903, to be imposed. A separate base may consist, for example, of a particular type of income or of an amount unrelated to income, *e.g.*, wages paid. Amounts are not separately computed if they are computed separately merely for purposes of a preliminary computation and are then combined as a single base. In the case of levies that apply to dual capacity taxpayers, see also §1.901–2A(a).

(2) *Contractual modifications.* Notwithstanding paragraph (d)(1) of this section, if foreign law imposing a levy is modified for one or more persons subject to the levy by a contract entered into by such person or persons and the foreign country, then foreign law is considered for purposes of sections 901 and 903 to impose a separate levy for all persons to whom such contractual modification of the levy applies, as contrasted to the levy as applied to all persons to whom such contractual modification does not apply. In applying the provisions of paragraph (c) of this section to a tax as modified by such a contract, the provisions of §1.903–1(b)(2) shall apply.

(3) *Examples.* The provisions of paragraph (d)(1) of this section may be illustrated by the following examples:

Example 1. A foreign statute imposes a levy on corporations equal to the sum of 15% of the corporation's realized net income plus 3% of its net worth. As the levy is the sum of two separately computed amounts, each of which is computed by reference to a separate base, each of the portion of the levy based on income and the portion of the levy based on net worth is considered, for purposes of sections 901 and 903, to be a separate levy.

Example 2. A foreign statute imposes a levy on nonresident alien individuals analogous to the taxes imposed by section 871 of the Internal Revenue Code. For the same reasons as set forth in example 1, each of the portion of the foreign levy analogous to the tax imposed by section 871(a) and the portion of the foreign levy analogous to the tax imposed by sections 871 (b) and 1, is considered, for purposes of sections 901 and 903, to be a separate levy.

Example 3. A single foreign statute or separate foreign statutes impose a foreign levy that is the sum of the products of specified rates applied to specified bases, as follows:

Base	Rate (percent)
Net income from mining	45
Net income from manufacturing	50
Net income from technical services	50
Net income from other services	45
Net income from investments	15
All other net income	50

In computing each such base, deductible expenditures are allocated to the type of income they generate. If allocated deductible expenditures exceed the gross amount of a specified type of income, the excess may not be applied against income of a different specified type. Accordingly, the levy is the sum of several separately computed amounts, each of which is computed by reference to a separate base. Each of the levies on mining net income, manufacturing net income, technical services net income, other services net income, investment net income and other net income is, therefore, considered, for purposes of sections 901 and 903, to be a separate levy.

Example 4. The facts are the same as in example 3, except that excess deductible expenditures allocated to one type of income are applied against other types of income to which the same rate applies. The levies on mining net income and other services net income together are considered, for purposes of sections 901 and 903, to be a single levy since, despite a separate preliminary computation

of the bases, by reason of the permitted application of excess allocated deductible expenditures, the bases are not separately computed. For the same reason, the levies on manufacturing net income, technical services net income and other net income together are considered, for purposes of sections 901 and 903, to be a single levy. The levy on investment net income is considered, for purposes of sections 901 and 903, to be a separate levy. These results are not dependent on whether the application of excess allocated deductible expenditures to a different type of income, as described above, is permitted in the same taxable period in which the expenditures are taken into account for purposes of the preliminary computation, or only in a different (e.g., later) taxable period.

Example 5. The facts are the same as in example 3, except that excess deductible expenditures allocated to any type of income other than investment income are applied against the other types of income (including investment income) according to a specified set of priorities of application. Excess deductible expenditures allocated to investment income are not applied against any other type of income. For the reason expressed in example 4, all of the levies are together considered, for purposes of sections 901 and 903, to be a single levy.

(e) *Amount of income tax that is creditable*—(1) *In general.* Credit is allowed under section 901 for the amount of income tax (within the meaning of paragraph (a)(1) of this section) that is paid to a foreign country by the taxpayer. The amount of income tax paid by the taxpayer is determined separately for each taxpayer.

(2) *Refunds and credits*—(i) In general. An amount is not tax paid to a foreign country to the extent that it is reasonably certain that the amount will be refunded, credited, rebated, abated, or forgiven. It is not reasonably certain that an amount will be refunded, credited, rebated, abated, or forgiven if the amount is not greater than a reasonable approximation of final tax liability to the foreign country.

(ii) *Examples.* The provisions of paragraph (e)(2)(i) of this section may be illustrated by the following examples:

Example 1. The internal law of country X imposes a 25 percent tax on the gross amount of interest from sources in country X that is received by a nonresident of country X. Country X law imposes the tax on the nonresident recipient and requires any resident of country X that pays such interest to a nonresident to withhold and pay over to country X 25 percent of such interest, which is applied to offset the recipient's liability for the 25 percent tax. A tax treaty between the United States and country X overrides internal law of country X and provides that country X may not tax interest received by a resident of the United States from a resident of country X at a rate in excess of 10 percent of the gross amount of such interest. A resident of the United States may claim the benefit of the treaty only by applying for a refund of the excess withheld amount (15 percent of the gross amount of interest income) after the end of the taxable year. *A*, a resident of the United States, receives a gross amount of 100u (units of country X currency) of interest income from a resident of country X from sources in country X in the taxable year 1984, from which 25u of country X tax is withheld. *A* files a timely claim for refund of the 15u excess withheld amount. 15u of the amount withheld (25u–10u) is reasonably certain to be refunded; therefore 15u is not considered an amount of tax paid to country X.

Example 2. A's initial income tax liability under country X law is 100u (units of country X currency). However, under country X law *A's* initial income tax liability is reduced in order to compute its final tax liability by an investment credit of 15u and a credit for charitable contributions of 5u. The amount of income tax paid by *A* is 80u.

Example 3. A computes his income tax liability in country X for the taxable year 1984 as 100u (units of country X currency), files a tax return on that basis, and pays 100u of tax. The day after *A* files that return, *A* files a claim for refund of 90u. The difference between the 100u of liability reflected in *A's* original return and the 10u of liability reflected in *A's* refund claim depends on whether a particular expenditure made by *A* is nondeductible or deductible, respectively. Based on an analysis of the country X tax law, *A's* country X tax advisors have advised *A* that it is not clear whether or not that expenditure is deductible. In view of the uncertainty as to the proper treatment of the item in question under country X tax law, no portion of the 100u paid by *A* is reasonably certain to be refunded. If *A* receives a refund, *A* must treat the refund as required by section 905(c) of the Internal Revenue Code.

Example 4. A levy of country X, which qualifies as an income tax within the meaning of paragraph (a)(1) of this section, provides that each person who makes payment to country X pursuant to the levy will receive a bond to be issued by country X with an amount payable at maturity equal to 10 percent of the amount paid pursuant to the levy. *A* pays 38,000u (units of country X currency) to country X and is entitled to receive a bond with an amount payable at maturity of 3800u. It is reasonably certain that a refund in the form of property (the bond) will

be made. The amount of that refund is equal to the fair market value of the bond. Therefore, only the portion of the 38,000u payment in excess of the fair market value of the bond is an amount of tax paid.

(3) *Subsidies*—(i) *General rule.* An amount of foreign income tax is not an amount of income tax paid or accrued by a taxpayer to a foreign country to the extent that—

(A) The amount is used, directly or indirectly, by the foreign country imposing the tax to provide a subsidy by any means (including, but not limited to, a rebate, a refund, a credit, a deduction, a payment, a discharge of an obligation, or any other method) to the taxpayer, to a related person (within the meaning of section 482), to any party to the transaction, or to any party to a related transaction; and

(B) The subsidy is determined, directly or indirectly, by reference to the amount of the tax or by reference to the base used to compute the amount of the tax.

(ii) *Subsidy.* The term ''subsidy'' includes any benefit conferred, directly or indirectly, by a foreign country to one of the parties enumerated in paragraph (e)(3)(i)(A) of this section. Substance and not form shall govern in determining whether a subsidy exists. The fact that the U.S. taxpayer may derive no demonstrable benefit from the subsidy is irrelevant in determining whether a subsidy exists.

(iii) *Official exchange rate.* A subsidy described in paragraph (e)(3)(i)(B) of this section does not include the actual use of an official foreign government exchange rate converting foreign currency into dollars where a free exchange rate also exists if—

(A) The economic benefit represented by the use of the official exchange rate is not targeted to or tied to transactions that give rise to a claim for a foreign tax credit;

(B) The economic benefit of the official exchange rate applies to a broad range of international transactions, in all cases based on the total payment to be made without regard to whether the payment is a return of principal, gross income, or net income, and without regard to whether it is subject to tax; and

(C) Any reduction in the overall cost of the transaction is merely coincidental to the broad structure and operation of the official exchange rate.

In regard to foreign taxes paid or accrued in taxable years beginning before January 1, 1987, to which the Mexican Exchange Control Decree, effective as of December 20, 1982, applies, see Rev. Rul. 84–143, 1984–2 C.B. 127.

(iv) *Examples.* The provisions of this paragraph (e)(3) may be illustrated by the following examples:

Example 1. (i) Country X imposes a 30 percent tax on nonresident lenders with respect to interest which the nonresident lenders receive from borrowers who are residents of Country X, and it is established that this tax is a tax in lieu of an income tax within the meaning of §1.903–1(a). Country X provides the nonresident lenders with receipts upon their payment of the 30 percent tax. Country X remits to resident borrowers an incentive payment for engaging in foreign loans, which payment is an amount equal to 20 percent of the interest paid to nonresident lenders.

(ii) Because the incentive payment is based on the interest paid, it is determined by reference to the base used to compute the tax that is imposed on the nonresident lender. The incentive payment is considered a subsidy under this paragraph (e)(3) since it is provided to a party (the borrower) to the transaction and is based on the amount of tax that is imposed on the lender with respect to the transaction. Therefore, two-thirds (20 percent/30 percent) of the amount withheld by the resident borrower from interest payments to the nonresidential lender is not an amount of income tax paid or accrued for purposes of section 901(b).

Example 2. (i) A U.S. bank lends money to a development bank in Country X. The development bank relends the money to companies resident in Country X. A withholding tax is imposed by Country X on the U.S. bank with respect to the interest that the development bank pays to the U.S. bank, and appropriate receipts are provided. On the date that the tax is withheld, fifty percent of the tax is credited by Country X to an account of the development bank. Country X requires the development bank to transfer the amount credited to the borrowing companies.

(ii) The amount successively credited to the account of the development bank and then to the account of the borrowing companies is determined by reference to the amount of the tax and the tax base. Since the amount credited to the borrowing companies is a subsidy provided to a party (the borrowing companies) to a related transaction and is based on the amount of tax and

the tax base, it is not an amount paid or accrued as an income tax for purposes of section 901(b).

Example 3. (i) A U.S. bank lends dollars to a Country X borrower. Country X imposes a withholding tax on the lender with respect to the interest. The tax is to be paid in Country X currency, although the interest is payable in dollars. Country X has a dual exchange rate system, comprised of a controlled official exchange rate and a free exchange rate. Priority transactions such as exports of merchandise, imports of merchandise, and payments of principal and interest on foreign currency loans payable abroad to foreign lenders are governed by the official exchange rate which yields more dollars per unit of Country X currency than the free exchange rate. The Country X borrower remits the net amount of dollar interest due to the U.S. bank (interest due less withholding tax), pays the tax withheld in Country X currency to the Country X government, and provides to the U.S. bank a receipt for payment of the Country X taxes.

(ii) The use of the official exchange rate by the U.S. bank to determine foreign taxes with respect to interest is not a subsidy described in paragraph (e)(3)(i)(B) of this section. The official exchange rate is not targeted to or tied to transactions that give rise to a claim for a foreign tax credit. The use of the official exchange rate applies to the interest paid and to the principal paid. Any benefit derived by the U.S. bank through the use of the official exchange rate is merely coincidental to the broad structure and operation of the official exchange rate.

Example 4. (i) B, a U.S. corporation, is engaged in the production of oil and gas in Country X pursuant to a production sharing agreement between B, Country X, and the state petroleum authority of Country X. The agreement is approved and enacted into law by the Legislature of Country X. Both B and the petroleum authority are subject to the Country X income tax. Each entity files an annual income tax return and pays, to the tax authority of Country X, the amount of income tax due on its annual income. B is a dual capacity taxpayer as defined in §1.901–2(a)(2)(ii)(A). Country X has agreed to return to the petroleum authority one-half of the income taxes paid by B by allowing it a credit in calculating its own tax liability to Country X.

(ii) The petroleum authority is a party to a transaction with B and the amount returned by Country X to the petroleum authority is determined by reference to the amount of the tax imposed on B. Therefore, the amount returned is a subsidy as described in this paragraph (e)(3) and one-half the tax imposed on B is not an amount of income tax paid or accrued.

Example 5. Assume the same facts as in *Example 4*, except that the state petroleum authority of Country X does not receive amounts from Country X related to tax paid by B. Instead, the authority of Country X receives a general appropriation from Country X which is not calculated with reference to the amount of tax paid by B. The general appropriation is therefore not a subsidy described in this paragraph (e)(3).

(v) *Effective Date.* This paragraph (e)(3) shall apply to foreign taxes paid or accrued in taxable years beginning after December 31, 1986.

(4) *Multiple levies*—(i) *In general.* If, under foreign law, a taxpayer's tentative liability for one levy (the ''first levy'') is or can be reduced by the amount of the taxpayer's liability for a different levy (the ''second levy''), then the amount considered paid by the taxpayer to the foreign country pursuant to the second levy is an amount equal to its entire liability for that levy, and the remainder of the amount paid is considered paid pursuant to the first levy. This rule applies regardless of whether it is or is not likely that liability for one such levy will always exceed liability for the other such levy. For an example of the application of this rule, see example 5 of §1.903–1(b)(3). If, under foreign law, the amount of a taxpayer's liability is the greater or lesser of amounts computed pursuant to two levies, then the entire amount paid to the foreign country by the taxpayer is considered paid pursuant to the levy that imposes such greater or lesser amount, respectively, and no amount is considered paid pursuant to such other levy.

(ii) *Integrated tax systems.* [Reserved]

(5) *Noncompulsory amounts*—(i) *In general.* An amount paid is not a compulsory payment, and thus is not an amount of tax paid, to the extent that the amount paid exceeds the amount of liability under foreign law for tax. An amount paid does not exceed the amount of such liability if the amount paid is determined by the taxpayer in a manner that is consistent with a reasonable interpretation and application of the substantive and procedural provisions of foreign law (including applicable tax treaties) in such a way as to

reduce, over time, the taxpayer's reasonably expected liability under foreign law for tax, and if the taxpayer exhausts all effective and practical remedies, including invocation of competent authority procedures available under applicable tax treaties, to reduce, over time, the taxpayer's liability for foreign tax (including liability pursuant to a foreign tax audit adjustment). Where foreign tax law includes options or elections whereby a taxpayer's tax liability may be shifted, in whole or part, to a different year or years, the taxpayer's use or failure to use such options or elections does not result in a payment in excess of the taxpayer's liability for foreign tax. An interpretation or application of foreign law is not reasonable if there is actual notice or constructive notice (*e.g.*, a published court decision) to the taxpayer that the interpretation or application is likely to be erroneous. In interpreting foreign tax law, a taxpayer may generally rely on advice obtained in good faith from competent foreign tax advisors to whom the taxpayer has disclosed the relevant facts. A remedy is effective and practical only if the cost thereof (including the risk of offsetting or additional tax liability) is reasonable in light of the amount at issue and the likelihood of success. A settlement by a taxpayer of two or more issues will be evaluated on an overall basis, not on an issue-by-issue basis, in determining whether an amount is a compulsory amount. A taxpayer is not required to alter its form of doing business, its business conduct, or the form of any business transaction in order to reduce its liability under foreign law for tax.

(ii) *Examples*. The provisions of paragraph (e)(5)(i) of this section may be illustrated by the following examples:

Example 1. A, a corporation organized and doing business solely in the United States, owns all of the stock of *B*, a corporation organized in country X. In 1984 *A* buys merchandise from unrelated persons for $1,000,000, shortly thereafter resells that merchandise to *B* for $600,000, and *B* later in 1984 resells the merchandise to unrelated persons for $1,200,000. Under the country X income tax, which is an income tax within the meaning of paragraph (a)(1) of this section, all corporations organized in country X are subject to a tax equal to 3 percent of their net income. In computing its 1984 country X income tax liability *B* reports $600,000 ($1,200,000—$600,000) of profit from the purchase and resale of the merchandise referred to above. The country X income tax law requires that transactions between related persons be reported at arm's length prices, and a reasonable interpretation of this requirement, as it has been applied in country X, would consider *B*'s arm's length purchase price of the merchandise purchased from *A* to be $1,050,000. When it computes its country X tax liability *B* is aware that $600,000 is not an arm's length price (by country X standards). *B*'s knowing use of a non-arm's length price (by country X standards) of $600,000, instead of a price of $1,050,000 (an arm's length price under country X's law), is not consistent with a reasonable interpretation and application of the law of country X, determined in such a way as to reduce over time *B*'s reasonably expected liability for country X income tax. Accordingly, $13,500 (3 percent of $450,000 ($1,050,000—$600,000)), the amount of country X income tax paid by *B* to country X that is attributable to the purchase of the merchandise from *B*'s parent at less than an arm's length price, is in excess of the amount of *B*'s liability for country X tax, and thus is not an amount of tax.

Example 2. A, a corporation organized and doing business solely in the United States, owns all of the stock of *B*, a corporation organized in country X. Country X has in force an income tax treaty with the United States. The treaty provides that the profits of related persons shall be determined as if the persons were not related. *A* and *B* deal extensively with each other. *A* and *B*, with respect to a series of transactions involving both of them, treat *A* as having $300,000 of income and *B* as having $700,000 of income for purposes of *A*'s United States income tax and *B*'s country X income tax, respectively. *B* has no actual or constructive notice that its treatment of these transactions under country X law is likely to be erroneous. Subsequently, the Internal Revenue Service reallocates $200,000 of this income from *B* to *A* under the authority of section 482 and the treaty. This reallocation constitutes actual notice to *A* and constructive notice to *B* that *B*'s interpretation and application of country X's law and the tax treaty is likely to be erroneous. *B* does not exhaust all effective and practical remedies to obtain a refund of the amount of country X income tax paid by *B* to country X that is attributable to the reallocated $200,000 of income. This amount is in excess of the amount of *B*'s liability for country X tax and thus is not an amount of tax.

Example 3. The facts are the same as in example 2, except that *B* files a claim for refund (an administrative proceeding) of country X tax and *A* or *B* invokes the competent authority procedures of the treaty, the cost

of which is reasonable in view of the amount at issue and the likelihood of success, Nevertheless, *B* does not obtain any refund of country X tax. The cost of pursuing any judicial remedy in country X would be unreasonable in light of the amount at issue and the likelihood of *B*'s success, and *B* does not pursue any such remedy. The entire amount paid by *B* to country X is a compulsory payment and thus is an amount of tax paid by *B*.

Example 4. The facts are the same as in example 2, except that, when the Internal Revenue Service makes the reallocation, the country X statute of limitations on refunds has expired; and neither the internal law of country X nor the treaty authorizes the country X tax authorities to pay a refund that is barred by the statute of limitations. *B* does not file a claim for refund, and neither *A* nor *B* invokes the competent authority procedures of the treaty. Because the country X tax authorities would be barred by the statute of limitations from paying a refund, *B* has no effective and practicable remedies. The entire amount paid by *B* to country X is a compulsory payment and thus is an amount of tax paid by *B*.

Example 5. A is a U.S. person doing business in country X. In computing its income tax liability to country X, *A* is permitted, at its election, to recover the cost of machinery used in its business either by deducting that cost in the year of acquisition or by depreciating that cost on the straight line method over a period of 2, 4, 6 or 10 years. *A* elects to depreciate machinery over 10 years. This election merely shifts *A's* tax liability to different years (compared to the timing of *A's* tax liability under a different depreciation period); it does not result in a payment in excess of the amount of *A*'s liability for country X income tax in any year since the amount of country X tax paid by *A* is consistent with a reasonable interpretation of country X law in such a way as to reduce over time *A*'s reasonably expected liability for country X tax. Because the standard of paragraph (e)(5(i) of this section refers to *A*'s reasonably expected liability, not its actual liability, events actually occurring in subsequent years (e.g. whether *A* has sufficient profit in such years so that such depreciation deductions actually reduce *A*'s country X tax liability or whether the country X tax rates change) are immaterial.

Example 6. The internal law of country X imposes a 25 percent tax on the gross amount of interest from sources in country X that is received by a nonresident of country X. Country X law imposes the tax on the nonresident recipient and requires any resident of country X that pays such interest to a nonresident to withhold and pay over to country X 25 percent of such interest, which is applied to offset the recipient's liability for the 25 percent tax. A tax treaty between the United States and country X overrides internal law of country X and provides that country X may not tax interest received by a resident of the United States from a resident of country X at a rate in excess of 10 percent of the gross amount of such interest. A resident of the United States may claim the benefit of the treaty only by applying for a refund of the excess withheld amount (15 percent of the gross amount of interest income) after the end of the taxable year. A, a resident of the United States, receives a gross amount of 100u (units of country X currency) of interest income from a resident of country X from sources in country X in the taxable year 1984, from which 25u of country X tax is withheld. *A* does not file a timely claim for refund. 15u of the amount withheld (25u–10u) is not a compulsory payment and hence is not an amount of tax.

(iii) [Reserved]

(iv) *Structured passive investment arrangements*—(A) *In general.* Notwithstanding paragraph (e)(5)(i) of this section, an amount paid to a foreign country (a ''foreign payment'') is not a compulsory payment, and thus is not an amount of tax paid, if the foreign payment is attributable (within the meaning of paragraph (e)(5)(iv)(B)(*1*)(*ii*) of this section) to a structured passive investment arrangement (as described in paragraph (e)(5)(iv)(B) of this section).

(B) *Conditions.* An arrangement is a structured passive investment arrangement if all of the following conditions are satisfied:

(*1*) *Special purpose vehicle (SPV).* An entity that is part of the arrangement meets the following requirements:

(*i*) Substantially all of the gross income (for U.S. tax purposes) of the entity, if any, is passive investment income, and substantially all of the assets of the entity are assets held to produce such passive investment income.

(*ii*) There is a foreign payment attributable to income of the entity (as determined under the laws of the foreign country to which such foreign payment is made), including the entity's share of income of a lower-tier entity that is a branch or pass-through entity under the laws of such foreign country, that, if the foreign payment were an amount of tax paid, would be paid or accrued in a U.S. taxable year in which the entity meets the requirements of paragraph (e)(5)(iv)(B)(*1*)(*i*) of this section. A foreign payment attributable to income of an entity includes a foreign payment

attributable to income that is required to be taken into account by an owner of the entity, if the entity is a branch or pass-through entity under the laws of such foreign country. A foreign payment attributable to income of the entity also includes a withholding tax (within the meaning of section 901(k)(1)(B)) imposed on a dividend or other distribution (including distributions made by a pass-through entity or an entity that is disregarded as an entity separate from its owner for U.S. tax purposes) with respect to the equity of the entity.

(*2*) *U.S. party*. A person would be eligible to claim a credit under section 901(a) (including a credit for foreign taxes deemed paid under section 902 or 960) for all or a portion of the foreign payment described in paragraph (e)(5)(iv)(B)(*1*)(*ii*) of this section if the foreign payment were an amount of tax paid.

(*3*) *Direct investment*. The U.S. party's proportionate share of the foreign payment or payments described in paragraph (e)(5)(iv)(B)(*1*)(*ii*) of this section is (or is expected to be) substantially greater than the amount of credits, if any, that the U.S. party reasonably would expect to be eligible to claim under section 901(a) for foreign taxes attributable to income generated by the U.S. party's proportionate share of the assets owned by the SPV if the U.S. party directly owned such assets. For this purpose, direct ownership shall not include ownership through a branch, a permanent establishment or any other arrangement (such as an agency arrangement or dual resident status) that would result in the income generated by the U.S. party's proportionate share of the assets being subject to tax on a net basis in the foreign country to which the payment is made. A U.S. party's proportionate share of the assets of the SPV shall be determined by reference to such U.S. party's proportionate share of the total value of all of the outstanding interests in the SPV that are held by its equity owners and creditors. A U.S. party's proportionate share of the assets of the SPV, however, shall not include any assets that produce income subject to gross basis withholding tax.

(*4*) *Foreign tax benefit*. The arrangement is reasonably expected to result in a credit, deduction, loss, exemption, exclusion or other tax benefit under the laws of a foreign country that is available to a counterparty or to a person that is related to the counterparty (determined under the principles of paragraph (e)(5)(iv)(C)(*7*) of this section by applying the tax laws of a foreign country in which the counterparty is subject to tax on a net basis). However, a foreign tax benefit in the form of a credit is described in this paragraph (e)(5)(iv)(B)(*4*) only if the amount of any such credit corresponds to 10 percent or more of the amount of the U.S. party's share (for U.S. tax purposes) of the foreign payment referred to in paragraph (e)(5)(iv)(B)(*1*)(*ii*) of this section. In addition, a foreign tax benefit in the form of a deduction, loss, exemption, exclusion or other tax benefit is described in this paragraph (e)(5)(iv)(B)(*4*) only if such amount corresponds to 10 percent or more of the foreign base with respect to which the U.S. party's share (for U.S. tax purposes) of the foreign payment is imposed. For purposes of the preceding two sentences, if an arrangement involves more than one U.S. party or more than one counterparty or both, the aggregate amount of foreign tax benefits available to all of the counterparties and persons related to such counterparties is compared to the aggregate amount of all of the U.S. parties' shares of the foreign payment or foreign base, as the case may be. Where a U.S. party indirectly owns interests in an SPV that are treated as equity interests for both U.S. and foreign tax purposes, a foreign tax benefit available to a foreign entity in the chain of ownership that begins with the SPV and ends with the first-tier entity in the chain does not correspond to the U.S. party's share of the foreign payment attributable to income of the SPV to the extent that such benefit relates to earnings of the SPV that are distributed with respect to equity interests in the SPV that are owned directly or indirectly by the U.S. party for purposes of both U.S. and foreign tax law.

(*5*) *Counterparty*. The arrangement involves a counterparty. A counterparty

is a person that, under the tax laws of a foreign country in which the person is subject to tax on the basis of place of management, place of incorporation or similar criterion or otherwise subject to a net basis tax, directly or indirectly owns or acquires equity interests in, or assets of, the SPV. However, a counterparty does not include the SPV or a person with respect to which for U.S. tax purposes the same domestic corporation, U.S. citizen or resident alien individual directly or indirectly owns more than 80 percent of the total value of the stock (or equity interests) of each of the U.S. party and such person. A counterparty also does not include a person with respect to which for U.S. tax purposes the U.S. party directly or indirectly owns more than 80 percent of the total value of the stock (or equity interests), but only if the U.S. party is a domestic corporation, a U.S. citizen or a resident alien individual. In addition, a counterparty does not include an individual who is a U.S. citizen or resident alien.

(*6*) *Inconsistent treatment*. The United States and an applicable foreign country treat one or more of the aspects of the arrangement listed in paragraph (e)(5)(iv)(B)(*6*)(*i*) through (e)(5)(iv)(B)(*6*)(*iv*) of this section differently under their respective tax systems, and for one or more tax years when the arrangement is in effect one or both of the following two conditions applies; either the amount of income attributable to the SPV that is recognized for U.S. tax purposes by the SPV, the U.S. party or parties, and persons related to a U.S. party or parties is materially less than the amount of income that would be recognized if the foreign tax treatment controlled for U.S. tax purposes; or the amount of credits claimed by the U.S. party or parties (if the foreign payment described in paragraph (e)(5)(iv)(B)(*1*)(*ii*) of this section were an amount of tax paid) is materially greater than it would be if the foreign tax treatment controlled for U.S. tax purposes:

(*i*) The classification of the SPV (or an entity that has a direct or indirect ownership interest in the SPV) as a corporation or other entity subject to an entity-level tax, a partnership or other flow-through entity or an entity that is disregarded for tax purposes.

(*ii*) The characterization as debt, equity or an instrument that is disregarded for tax purposes of an instrument issued by the SPV (or an entity that has a direct or indirect ownership interest in the SPV) to a U.S. party, a counterparty or a person related to a U.S. party or a counterparty.

(*iii*) The proportion of the equity of the SPV (or an entity that directly or indirectly owns the SPV) that is considered to be owned directly or indirectly by a U.S. party and a counterparty.

(*iv*) The amount of taxable income that is attributable to the SPV for one or more tax years during which the arrangement is in effect.

(C) *Definitions*. The following definitions apply for purposes of paragraph (e)(5)(iv) of this section.

(*1*) *Applicable foreign country*. An *applicable foreign country* means each foreign country to which a foreign payment described in paragraph (e)(5)(iv)(B)(*1*)(*ii*) of this section is made or which confers a foreign tax benefit described in paragraph (e)(5)(iv)(B)(*4*) of this section.

(*2*) *Counterparty*. The term *counterparty* means a person described in paragraph (e)(5)(iv)(B)(*5*) of this section.

(*3*) *Entity*. The term *entity* includes a corporation, trust, partnership or disregarded entity described in § 301.7701–2(c)(2)(i).

(*4*) *Indirect ownership*. Indirect ownership of stock or another equity interest (such as an interest in a partnership) shall be determined in accordance with the principles of section 958(a)(2), regardless of whether the interest is owned by a U.S. or foreign entity.

(*5*) *Passive investment income*—(*i*) *In general*. The term *passive investment income* means income described in section 954(c), as modified by this paragraph (e)(5)(iv)(C)(*5*)(*i*) and paragraph (e)(5)(iv)(C)(*5*)(*ii*) of this section. In determining whether income is described in section 954(c), paragraphs (c)(1)(H), (c)(3), and (c)(6) of that section shall be disregarded. Sections 954(c), 954(h), and 954(i) shall be applied at the entity level as if the entity (as defined in

paragraph (e)(5)(iv)(C)(*3*) of this section) were a controlled foreign corporation (as defined in section 957(a)). For purposes of determining if sections 954(h) and 954(i) apply for purposes of this paragraph (e)(5)(iv)(C)(*5*)(*i*) and paragraph (e)(5)(iv)(C)(*5*)(*ii*) of this section, any income of an entity attributable to transactions that, assuming the entity is an SPV, are with a person that is a counterparty, or with persons that are related to a counterparty within the meaning of paragraph (e)(5)(iv)(B)(*4*) of this section, shall not be treated as qualified banking or financing income or as qualified insurance income, and shall not be taken into account in applying sections 954(h) and 954(i) for purposes of determining whether other income of the entity is excluded from section 954(c)(1) under section 954(h) or 954(i), but only if any such person (or a person that is related to such person within the meaning of paragraph (e)(5)(iv)(B)(*4*) of this section) is eligible for a foreign tax benefit described in paragraph (e)(5)(iv)(B)(*4*) of this section. In addition, in applying section 954(h) for purposes of this paragraph (e)(5)(iv)(C)(*5*)(*i*) and paragraph (e)(5)(iv)(C)(*5*)(*ii*) of this section, section 954(h)(3)(E) shall not apply, section 954(h)(2)(A)(ii) shall be satisfied only if the entity conducts substantial activity with respect to its business through its own employees, and the term ''any foreign country'' shall be substituted for ''home country'' wherever it appears in section 954(h).

(*ii*) *Income attributable to lower-tier entities; holding company exception.* Income of an upper-tier entity that is attributable to an equity interest in a lower-tier entity, including dividends, an allocable share of partnership income, and income attributable to the ownership of an interest in an entity that is disregarded as an entity separate from its owner is passive investment income unless substantially all of the upper-tier entity's assets consist of qualified equity interests in one or more lower-tier entities, each of which is engaged in the active conduct of a trade or business and derives more than 50 percent of its gross income from such trade or business, and substantially all of the upper-tier entity's opportunity for gain and risk of loss with respect to each such interest in a lower-tier entity is shared by the U.S. party (or persons that are related to a U.S. party) and, assuming the entity is an SPV, a counterparty (or persons that are related to a counterparty) (''holding company exception''). If an arrangement involves more than one U.S. party or more than one counterparty or both, then substantially all of the upper-tier entity's opportunity for gain and risk of loss with respect to its interest in any lower-tier entity must be shared (directly or indirectly) by one or more U.S. parties (or persons related to such U.S. parties) and, assuming the upper-tier entity is an SPV, one or more counterparties (or persons related to such counterparties). Substantially all of the upper-tier entity's opportunity for gain and risk of loss with respect to its interest in any lower-tier entity is not shared if the opportunity for gain and risk of loss is borne (directly or indirectly) by one or more U.S. parties (or persons related to such U.S. party or parties) or, assuming the upper-tier entity is an SPV, by one or more counterparties (or persons related to such counterparty or counterparties). Whether and the extent to which a person is considered to share in an upper-tier entity's opportunity for gain and risk of loss is determined based on all the facts and circumstances, provided, however, that a person does not share in an upper-tier entity's opportunity for gain and risk of loss if its equity interest in the upper-tier entity was acquired in a sale-repurchase transaction or if its interest is treated as debt for U.S. tax purposes. If a U.S. party owns an interest in an entity indirectly through a chain of entities, the application of the holding company exception begins with the lowest-tier entity in the chain that may satisfy the holding company exception and proceeds upward; provided, however, that the opportunity for gain and risk of loss borne by any upper-tier entity in the chain that is a counterparty shall be disregarded to the extent borne indirectly by a U.S. party. An upper-tier entity that satisfies the holding company exception is itself considered to be engaged in the active conduct of a trade or business

and to derive more than 50 percent of its gross income from such trade or business for purposes of applying the holding company exception to the owners of such entity. A lower-tier entity that is engaged in a banking, financing, or similar business shall not be considered to be engaged in the active conduct of a trade or business unless the income derived by such entity would be excluded from section 954(c)(1) under section 954(h) or 954(i) as modified by paragraph (e)(5)(iv)(C)(*5*)(*i*) of this section.

(*6*) *Qualified equity interest*. With respect to an interest in a corporation, the term *qualified equity interest* means stock representing 10 percent or more of the total combined voting power of all classes of stock entitled to vote and 10 percent or more of the total value of the stock of the corporation or disregarded entity, but does not include any preferred stock (as defined in section 351(g)(3)). Similar rules shall apply to determine whether an interest in an entity other than a corporation is a qualified equity interest.

(*7*) *Related person*. Two persons are related if—

(*i*) One person directly or indirectly owns stock (or an equity interest) possessing more than 50 percent of the total value of the other person; or

(*ii*) The same person directly or indirectly owns stock (or an equity interest) possessing more than 50 percent of the total value of both persons.

(*8*) *Special purpose vehicle (SPV)*. The term *SPV* means the entity described in paragraph (e)(5)(iv)(B)(*1*) of this section.

(*9*) *U.S. party*. The term *U.S. party* means a person described in paragraph (e)(5)(iv)(B)(*2*) of this section.

(D) *Examples*. The following examples illustrate the rules of paragraph (e)(5)(iv) of this section. No inference is intended as to whether a taxpayer would be eligible to claim a credit under section 901(a) if a foreign payment were an amount of tax paid. The examples set forth below do not limit the application of other principles of existing law to determine the proper tax consequences of the structures or transactions addressed in the regulations.

Example 1. U.S. borrower transaction. (i) *Facts.* A domestic corporation (USP) forms a country M corporation (Newco), contributing $1.5 billion in exchange for 100% of the stock of Newco. Newco, in turn, loans the $1.5 billion to a second country M corporation (FSub) wholly owned by USP. USP then sells its entire interest in Newco to a country M corporation (FP) for the original purchase price of $1.5 billion, subject to an obligation to repurchase the interest in five years for $1.5 billion. The sale has the effect of transferring ownership of the Newco stock to FP for country M tax purposes. Assume the sale-repurchase transaction is structured in a way that qualifies as a collateralized loan for U.S. tax purposes. Therefore, USP remains the owner of the Newco stock for U.S. tax purposes. In year 1, FSub pays Newco $120 million of interest. Newco pays $36 million to country M with respect to such interest income and distributes the remaining $84 million to FP. Under country M law, the $84 million distribution is excluded from FP's income. None of FP's stock is owned, directly or indirectly, by USP or any shareholders of USP that are domestic corporations, U.S. citizens, or resident alien individuals. Under an income tax treaty between country M and the United States, country M does not impose country M tax on interest received by U.S. residents from sources in country M.

(ii) *Result.* The $36 million payment by Newco to country M is not a compulsory payment, and thus is not an amount of tax paid because the foreign payment is attributable to a structured passive investment arrangement. First, Newco is an SPV because all of Newco's income is passive investment income described in paragraph (e)(5)(iv)(C)(*5*) of this section; Newco's only asset, a note, is held to produce such income; the payment to country M is attributable to such income; and if the payment were an amount of tax paid it would be paid or accrued in a U.S. taxable year in which Newco meets the requirements of paragraph (e)(5)(iv)(B)(*1*)(*i*) of this section. Second, if the foreign payment were treated as an amount of tax paid, USP would be deemed to pay the foreign payment under section 902(a) and, therefore, would be eligible to claim a credit for such payment under section 901(a). Third, USP would not pay any country M tax if it directly owned Newco's loan receivable. Fourth, the distribution from Newco to FP is exempt from tax under country M law, and the exempt amount corresponds to more than 10% of the foreign base with respect to which USP's share (which is 100% under U.S. tax law) of the foreign payment was imposed. Fifth, FP is a counterparty because FP owns stock of Newco under country M law and none of FP's stock is owned by USP or shareholders of USP that are domestic corporations, U.S. citizens, or resident alien individuals. Sixth, FP is the owner of 100% of Newco's stock for

country M tax purposes, while USP is the owner of 100% of Newco's stock for U.S. tax purposes, and the amount of credits claimed by USP if the payment to country M were an amount of tax paid is materially greater than it would be if country M tax treatment controlled for U.S. tax purposes such that FP, rather than USP, owned 100% of Newco's stock. Because the payment to country M is not an amount of tax paid, USP is not deemed to pay any country M tax under section 902(a). USP has dividend income of $84 million and also has interest expense of $84 million. FSub's post-1986 undistributed earnings are reduced by $120 million of interest expense.

Example 2. U.S. borrower transaction. (i) *Facts.* The facts are the same as in *Example 1*, except that FSub is a wholly-owned subsidiary of Newco. In addition, assume FSub is engaged in the active conduct of manufacturing and selling widgets and derives more than 50% of its gross income from such business.

(ii) *Result.* The results are the same as in *Example 1.* Although Newco wholly owns FSub, which is engaged in the active conduct of manufacturing and selling widgets and derives more than 50% of its income from such business, Newco's income that is attributable to Newco's equity interest in FSub is passive investment income because the sale-repurchase transaction limits FP's interest in Newco and its assets to that of a creditor, so that substantially all of Newco's opportunity for gain and risk of loss with respect to its stock in FSub is borne by USP. See paragraph (e)(5)(iv)(C)(*5*)(*ii*) of this section. Accordingly, Newco's stock in FSub is held to produce passive investment income. Thus, Newco is an SPV because all of Newco's income is passive investment income described in paragraph (e)(5)(iv)(C)(*5*) of this section, Newco's assets are held to produce such income, the payment to country M is attributable to such income, and if the payment were an amount of tax paid it would be paid or accrued in a U.S. taxable year in which Newco meets the requirements of paragraph (e)(5)(iv)(B)(*1*)(*i*) of this section.

Example 3. U.S. borrower transaction. (i) *Facts.* (A) A domestic corporation (USP) loans $750 million to its wholly-owned domestic subsidiary (Sub). USP and Sub form a country M partnership (Partnership) to which each contributes $750 million. Partnership loans all of its $1.5 billion of capital to Issuer, a wholly-owned country M affiliate of USP, in exchange for a note and coupons providing for the payment of interest at a fixed rate over a five-year term. Partnership sells all of the coupons to Coupon Purchaser, a country N partnership owned by a country M corporation (Foreign Bank) and a wholly-owned country M subsidiary of Foreign Bank, for $300 million. At the time of the coupon sale, the fair market value of the coupons sold is $290 million and, pursuant to section 1286(b)(3), Partnership's basis allocated to the coupons sold is $290 million. Several months later and prior to any interest payments on the note, Foreign Bank and its subsidiary sell all of their interests in Coupon Purchaser to an unrelated country O corporation for $280 million. None of Foreign Bank's stock or its subsidiary's stock is owned, directly or indirectly, by USP or Sub or by any shareholders of USP or Sub that are domestic corporations, U.S. citizens, or resident alien individuals.

(B) Assume that both the United States and country M respect the sale of the coupons for tax law purposes. In the year of the coupon sale, for country M tax purposes USP's and Sub's shares of Partnership's profits total $300 million, a payment of $60 million to country M is made with respect to those profits, and Foreign Bank and its subsidiary, as partners of Coupon Purchaser, are entitled to deduct the $300 million purchase price of the coupons from their taxable income. For U.S. tax purposes, USP and Sub recognize their distributive shares of the $10 million premium income and claim a direct foreign tax credit for their shares of the $60 million payment to country M. Country M imposes no additional tax when Foreign Bank and its subsidiary sell their interests in Coupon Purchaser. Country M also does not impose country M tax on interest received by U.S. residents from sources in country M.

(ii) *Result.* The payment to country M is not a compulsory payment, and thus is not an amount of tax paid, because the foreign payment is attributable to a structured passive investment arrangement. First, Partnership is an SPV because all of Partnership's income is passive investment income described in paragraph (e)(5)(iv)(C)(*5*) of this section; Partnership's only asset, Issuer's note, is held to produce such income; the payment to country M is attributable to such income; and if the payment were an amount of tax paid, it would be paid or accrued in a U.S. taxable year in which Partnership meets the requirements of paragraph (e)(5)(iv)(B)(*1*)(*i*) of this section. Second, if the foreign payment were an amount of tax paid, USP and Sub would be eligible to claim a credit for such payment under section 901(a). Third, USP and Sub would not pay any country M tax if they directly owned Issuer's note. Fourth, for country M tax purposes, Foreign Bank and its subsidiary deduct the $300 million purchase price of the coupons and are exempt from country M tax on the $280 million received upon the sale of Coupon Purchaser, and the deduction and exemption correspond to more than 10% of the $300 million base with respect to which USP's and Sub's 100% share of the foreign payments was imposed. Fifth, Foreign Bank and its subsidiary are counterparties because

they indirectly acquired assets of Partnership, the interest coupons on Issuer's note, and are not directly or indirectly owned by USP or Sub or shareholders of USP or Sub that are domestic corporations, U.S. citizens, or resident alien individuals. Sixth, the amount of taxable income of Partnership for one or more years is different for U.S. and country M tax purposes, and the amount of income attributable to USP and Sub for U.S. tax purposes is materially less than the amount of income they would recognize if the country M tax treatment of the coupon sale controlled for U.S. tax purposes. Because the payment to country M is not an amount of tax paid, USP and Sub are not considered to pay tax under section 901. USP and Sub have income of $10 million in the year of the coupon sale.

Example 4. Active business; no SPV. (i) *Facts.* A, a domestic corporation, wholly owns B, a country X corporation engaged in the manufacture and sale of widgets. On January 1, year 1, C, also a country X corporation, loans $400 million to B in exchange for an instrument that is debt for U.S. tax purposes and equity in B for country X tax purposes. As a result, C is considered to own stock of B for country X tax purposes. B loans $55 million to D, a country Y corporation wholly owned by A. In year 1, B has $166 million of net income attributable to its sales of widgets and $3.3 million of interest income attributable to the loan to D. Substantially all of B's assets are used in its widget business. Country Y does not impose tax on interest paid to nonresidents. B makes a payment of $50.8 million to country X with respect to B's net income. Country X does not impose tax on dividend payments between country X corporations. None of C's stock is owned, directly or indirectly, by A or by any shareholders of A that are domestic corporations, U.S. citizens, or resident alien individuals.

(ii) *Result.* B is not an SPV within the meaning of paragraph (e)(5)(iv)(B)(*1*) of this section because the amount of interest income received from D does not constitute substantially all of B's income and the $55 million note from D does not constitute substantially all of B's assets. Accordingly, the $50.8 million payment to country X is not attributable to a structured passive investment arrangement.

Example 5. U.S. lender transaction. (i) *Facts.* (A) A country X corporation (Foreign Bank) contributes $2 billion to a newly-formed country X company (Newco) in exchange for 90% of the common stock of Newco and securities that are treated as debt of Newco for U.S. tax purposes and preferred stock of Newco for country X tax purposes. A domestic corporation (USP) contributes $1 billion to Newco in exchange for 10% of Newco's common stock and securities that are treated as preferred stock of Newco for U.S. tax purposes and debt of Newco for country X tax purposes. Newco loans the $3 billion to a wholly-owned, country X subsidiary of Foreign Bank (FSub) in return for a $3 billion, seven-year note paying interest currently. The Newco securities held by USP entitle the holder to fixed distributions of $4 million per year, and the Newco securities held by Foreign Bank entitle the holder to receive $82 million per year, payable only on maturity of the $3 billion FSub note in year 7. At the end of year 5, pursuant to a prearranged plan, Foreign Bank acquires USP's Newco stock and securities for a prearranged price of $1 billion. Country X does not impose tax on dividends received by one country X corporation from a second country X corporation. Under an income tax treaty between country X and the United States, country X does not impose country X tax on interest received by U.S. residents from sources in country X. None of Foreign Bank's stock is owned, directly or indirectly, by USP or any shareholders of USP that are domestic corporations, U.S. citizens, or resident alien individuals.

(B) In each of years 1 through 7, FSub pays Newco $124 million of interest on the $3 billion note. Newco distributes $4 million to USP in each of years 1 through 5. The distributions are deductible for country X tax purposes, and Newco pays country X $36 million with respect to $120 million of taxable income from the FSub note in each year. For U.S. tax purposes, in each year Newco's post-1986 undistributed earnings are increased by $124 million of interest income and reduced by accrued interest expense with respect to the Newco securities held by Foreign Bank.

(ii) *Result.* The $36 million payment to country X is not a compulsory payment, and thus is not an amount of tax paid, because the foreign payment is attributable to a structured passive investment arrangement. First, Newco is an SPV because all of Newco's income is passive investment income described in paragraph (e)(5)(iv)(C)(*5*) of this section; Newco's only asset, a note of FSub, is held to produce such income; the payment to country X is attributable to such income; and if the payment were an amount of tax paid it would be paid or accrued in a U.S. taxable year in which Newco meets the requirements of paragraph (e)(5)(iv)(B)(*1*)(*i*) of this section. Second, if the foreign payment were an amount of tax paid, USP would be deemed to pay its pro rata share of the foreign payment under section 902(a) in each of years 1 through 5 and, therefore, would be eligible to claim a credit under section 901(a). Third, USP would not pay any country X tax if it directly owned its proportionate share of Newco's assets, a note of FSub. Fourth, for country X tax purposes, Foreign Bank is eligible to receive a tax-free distribution of $82 million attributable to each of years 1 through 5, and that amount corresponds to more than 10% of the foreign

base with respect to which USP's share of the foreign payment was imposed. Fifth, Foreign Bank is a counterparty because it owns stock of Newco for country X tax purposes and none of Foreign Bank's stock is owned, directly or indirectly, by USP or shareholders of USP that are domestic corporations, U.S. citizens, or resident alien individuals. Sixth, the United States and country X treat various aspects of the arrangement differently, including whether the Newco securities held by Foreign Bank and USP are debt or equity. The amount of credits claimed by USP if the payment to country X were an amount of tax paid is materially greater than it would be if the country X tax treatment controlled for U.S. tax purposes such that the securities held by USP were treated as debt or the securities held by Foreign Bank were treated as equity, and the amount of income recognized by Newco for U.S. tax purposes is materially less than the amount of income recognized for country X tax purposes. Because the payment to country X is not an amount of tax paid, USP is not deemed to pay any country X tax under section 902(a). USP has dividend income of $4 million in each of years 1 through 5.

Example 6. Holding company; no SPV. (i) *Facts.* A, a country X corporation, and B, a domestic corporation, each contribute $1 billion to a newly-formed country X entity (C) in exchange for 50% of the common stock of C. C is treated as a corporation for country X purposes and a partnership for U.S. tax purposes. C contributes $1.95 billion to a newly-formed country X corporation (D) in exchange for 100% of D's common stock. C loans its remaining $50 million to D. Accordingly, C's sole assets are stock and debt of D. D uses the entire $2 billion to engage in the business of manufacturing and selling widgets. In year 1, D derives $300 million of income from its widget business and derives $2 million of interest income. Also in year 1, C has dividend income of $200 million and interest income of $3.2 million with respect to its investment in D. Country X does not impose tax on dividends received by one country X corporation from a second country X corporation. C makes a payment of $960,000 to country X with respect to C's net income.

(ii) *Result.* C qualifies for the holding company exception described in paragraph (e)(5)(iv)(C)(*5*)(*ii*) of this section because C holds a qualified equity interest in D, D is engaged in an active trade or business and derives more than 50% of its gross income from such trade or business, C's interest in D constitutes substantially all of C's assets, and A and B share in substantially all of C's opportunity for gain and risk of loss with respect to D. As a result, C's dividend income from D is not passive investment income and C's stock in D is not held to produce such income. Accordingly, C is not an SPV within the meaning of paragraph (e)(5)(iv)(B)(*1*) of this section, and the $960,000 payment to country X is not attributable to a structured passive investment arrangement.

Example 7. Holding company; no SPV. (i) *Facts.* The facts are the same as in *Example 6,* except that instead of loaning $50 million to D, C contributes the $50 million to E in exchange for 10% of the stock of E. E is a country Y corporation that is not engaged in the active conduct of a trade or business. Also in year 1, D pays no dividends to C, E pays $3.2 million in dividends to C, and C makes a payment of $960,000 to country X with respect to C's net income.

(ii) *Result.* C qualifies for the holding company exception described in paragraph (e)(5)(iv)(C)(*5*)(*ii*) of this section because C holds a qualified equity interest in D, D is engaged in an active trade or business and derives more than 50% of its gross income from such trade or business, C's interest in D constitutes substantially all of C's assets, and A and B share in substantially all of C's opportunity for gain and risk of loss with respect to D. As a result, less than substantially all of C's assets are held to produce passive investment income. Accordingly, C is not an SPV because it does not meet the requirements of paragraph (e)(5)(iv)(B)(*1*) of this section, and the $960,000 payment to country X is not attributable to a structured passive investment arrangement.

Example 8. Holding company; no SPV. (i) *Facts.* The facts are the same as in *Example 6,* except that B's $1 billion investment in C consists of 30% of C's common stock and 100% of C's preferred stock. A's $1 billion investment in C consists of 70% of C's common stock. B sells its preferred stock to F, a country X corporation, subject to a repurchase obligation. Assume that under country X tax law, but not U.S. tax law, F is treated as the owner of the preferred shares and receives a distribution in year 1 of $50 million. The remaining earnings are distributed 70% to A and 30% to B.

(ii) *Result.* C qualifies for the holding company exception described in paragraph (e)(5)(iv)(C)(*5*)(*ii*) of this section because C holds a qualified equity interest in D, D is engaged in an active trade or business and derives more than 50% of its gross income from such trade or business, and C's interest in D constitutes substantially all of C's assets. Additionally, although F does not share in C's opportunity for gain and risk of loss with respect to C's interest in D because F acquired its interest in C in a sale-repurchase transaction, B (the U.S. party) and in the aggregate A and F (who would be counterparties assuming C were an SPV) share in substantially all of C's opportunity for gain and risk of loss with respect to D and such opportunity for gain and risk of loss is not borne exclusively either by B or by A and F in the aggregate. Accordingly,

C's shares in D are not held to produce passive investment income and the $200 million dividend from D is not passive investment income. C is not an SPV within the meaning of paragraph (e)(5)(iv)(B)(*1*) of this section, and the $960,000 payment to country X is not attributable to a structured passive investment arrangement.

Example 9. Asset holding transaction. (i) *Facts.* (A) A domestic corporation (USP) contributes $6 billion of country Z debt obligations to a country Z entity (DE) in exchange for all of the class A and class B stock of DE. DE is a disregarded entity for U.S. tax purposes and a corporation for country Z tax purposes. A corporation unrelated to USP and organized in country Z (FC) contributes $1.5 billion to DE in exchange for all of the class C stock of DE. DE uses the $1.5 billion contributed by FC to redeem USP's class B stock. The terms of the class C stock entitle its holder to all income from DE, but FC is obligated immediately to contribute back to DE all distributions on the class C stock. USP and FC enter into—

(*1*) A contract under which USP agrees to buy after five years the class C stock for $1.5 billion; and

(*2*) An agreement under which USP agrees to pay FC periodic payments on $1.5 billion.

(B) The transaction is structured in such a way that, for U.S. tax purposes, there is a loan of $1.5 billion from FC to USP, and USP is the owner of the class C stock and the class A stock. In year 1, DE earns $400 million of interest income on the country Z debt obligations. DE makes a payment to country Z of $100 million with respect to such income and distributes the remaining $300 million to FC. FC contributes the $300 million back to DE. None of FC's stock is owned, directly or indirectly, by USP or shareholders of USP that are domestic corporations, U.S. citizens, or resident alien individuals. Assume that country Z imposes a withholding tax on interest income derived by U.S. residents.

(C) Country Z treats FC as the owner of the class C stock. Pursuant to country Z tax law, FC is required to report the $400 million of income with respect to the $300 million distribution from DE, but is allowed to claim credits for DE's $100 million payment to country Z. For country Z tax purposes, FC is entitled to current deductions equal to the $300 million contributed back to DE.

(ii) *Result.* The payment to country Z is not a compulsory payment, and thus is not an amount of tax paid because the payment is attributable to a structured passive investment arrangement. First, DE is an SPV because all of DE's income is passive investment income described in paragraph (e)(5)(iv)(C)(*5*) of this section; all of DE's assets are held to produce such income; the payment to country Z is attributable to such income; and if the payment were an amount of tax paid it would be paid or accrued in a U.S. taxable year in which DE meets the requirements of paragraph (e)(5)(iv)(B)(*1*)(*i*) of this section. Second, if the payment were an amount of tax paid, USP would be eligible to claim a credit for such amount under section 901(a). Third, USP's proportionate share of DE's foreign payment of $100 million is substantially greater than the amount of credits USP would be eligible to claim if it directly held its proportionate share of DE's assets, excluding any assets that would produce income subject to gross basis withholding tax if directly held by USP. Fourth, FC is entitled to claim a credit under country Z tax law for the payment and recognizes a deduction for the $300 million contributed to DE under country Z law. The credit claimed by FC corresponds to more than 10% of USP's share (for U.S. tax purposes) of the foreign payment and the deductions claimed by FC correspond to more than 10% of the base with respect to which USP's share of the foreign payment was imposed. Fifth, FC is a counterparty because FC is considered to own equity of DE under country Z law and none of FC's stock is owned, directly or indirectly, by USP or shareholders of USP that are domestic corporations, U.S. citizens, or resident alien individuals. Sixth, the United States and country X treat certain aspects of the transaction differently, including the proportion of equity owned in DE by USP and FC, and the amount of credits claimed by USP if the country Z payment were an amount of tax paid is materially greater than it would be if the country X tax treatment controlled for U.S. tax purposes such that FC, rather than USP, owned the class C stock. Because the payment to country Z is not an amount of tax paid, USP is not considered to pay tax under section 901. USP has $400 million of interest income.

Example 10. Loss surrender. (i) *Facts.* The facts are the same as in *Example 9*, except that the deductions attributable to the arrangement contribute to a loss recognized by FC for country Z tax purposes, and pursuant to a group relief regime in country Z FC elects to surrender the loss to its country Z subsidiary.

(ii) *Result.* The results are the same as in *Example 9.* The surrender of the loss to a related party is a foreign tax benefit that corresponds to the base with respect to which USP's share of the foreign payment was imposed.

Example 11. Joint venture; no foreign tax benefit. (i) *Facts.* FC, a country X corporation, and USC, a domestic corporation, each contribute $1 billion to a newly-formed country X entity (C) in exchange for stock of C. FC and U.S.C. are entitled to equal 50% shares of all of C's income, gain, expense and loss. C is treated as a corporation for country X purposes and a partnership for U.S. tax purposes. In year 1, C earns $200 million of net

passive investment income, makes a payment to country X of $60 million with respect to that income, and distributes $70 million to each of FC and USC. Country X does not impose tax on dividends received by one country X corporation from a second country X corporation.

(ii) *Result.* FC's tax-exempt receipt of $70 million, or its 50% share of C's profits, is not a foreign tax benefit within the meaning of paragraph (e)(5)(iv)(B)(*4*) of this section because it does not correspond to any part of the foreign base with respect to which USC's share of the foreign payment was imposed. Accordingly, the $60 million payment to country X is not attributable to a structured passive investment arrangement.

Example 12. Joint venture; no foreign tax benefit. (i) *Facts.* The facts are the same as in *Example 11,* except that C in turn contributes $2 billion to a wholly-owned and newly-formed country X entity (D) in exchange for stock of D. D is treated as a corporation for country X purposes and disregarded as an entity separate from its owner for U.S. tax purposes. C has no other assets and earns no other income. In year 1, D earns $200 million of passive investment income, makes a payment to country X of $60 million with respect to that income, and distributes $140 million to C.

(ii) *Result.* C's tax-exempt receipt of $140 million is not a foreign tax benefit within the meaning of paragraph (e)(5)(iv)(B)(*4*) of this section because it does not correspond to any part of the foreign base with respect to which USC's share of the foreign payment was imposed. Fifty percent of C's foreign tax exemption is not a foreign tax benefit within the meaning of paragraph (e)(5)(iv)(B)(*4*) because it relates to earnings of D that are distributed with respect to an equity interest in D that is owned indirectly by U.S.C. under both U.S. and foreign tax law. The remaining 50% of C's foreign tax exemption, as well as FC's tax-exempt receipt of $70 million from C, is also not a foreign tax benefit because it does not correspond to any part of the foreign base with respect to which USC's share of the foreign payment was imposed. Accordingly, the $60 million payment to country X is not attributable to a structured passive investment arrangement.

(f) *Taxpayer*—(1) *In general.* The person by whom tax is considered paid for purposes of sections 901 and 903 is the person on whom foreign law imposes legal liability for such tax, even if another person (e.g., a withholding agent) remits such tax. For purposes of this section, §1.901–2A and §1.903–1, the person on whom foreign law imposes such liability is referred to as the ''taxpayer.'' A foreign tax of a type described in paragraph (a)(2)(ii)(C) of this section is considered to be imposed on the recipients of wages if such tax is deducted from such wages under provisions that are comparable to section 3102 (a) and (b) of the Internal Revenue Code.

(2) *Party undertaking tax obligation as part of transaction*—(i) *In general.* Tax is considered paid by the taxpayer even if another party to a direct or indirect transaction with the taxpayer agrees, as a part of the transaction, to assume the taxpayer's foreign tax liability. The rules of the foregoing sentence apply notwithstanding anything to the contrary in paragraph (e)(3) of this section. See §1.901–2A for additional rules regarding dual capacity taxpayers.

(ii) *Examples.* The provisions of paragraphs (f)(1) and (2)(i) of this section may be illustrated by the following examples:

Example 1. Under a loan agreement between *A,* a resident of country X, and *B,* a United States person, *A* agrees to pay *B* a certain amount of interest net of any tax that country X may impose on *B* with respect to its interest income. Country X imposes a 10 percent tax on the gross amount of interest income received by nonresidents of country X from sources in country X, and it is established that this tax is a tax in lieu of an income tax within the meaning of §1.903–1(a). Under the law of country X this tax is imposed on the nonresident recipient, and any resident of country X that pays such interest to a nonresident is required to withhold and pay over to country X 10 percent of the amount of such interest, which is applied to offset the recipient's liability for the tax. Because legal liability for the tax is imposed on the recipient of such interest income, *B* is the taxpayer with respect to the country X tax imposed on *B's* interest income from *B*'s loan to *A*. Accordingly, *B*'s interest income for federal income tax purposes includes the amount of country X tax that is imposed on *B* with respect to such interest income and that is paid on *B's* behalf by *A* pursuant to the loan agreement, and, under paragraph (f)(2)(i) of this section, such tax is considered for purposes of section 903 to be paid by *B*.

Example 2. The facts are the same as in example 1, except that in collecting and receiving the interest *B* is acting as a nominee for, or agent of, *C,* who is a United States person. Because *C* (not *B*) is the beneficial owner of the interest, legal liability for the tax is imposed on *C*, not *B* (*C*'s nominee or agent). Thus, *C* is the taxpayer with respect to the country X tax imposed on *C*'s interest income from *C*'s loan to *A*. Accordingly, *C*'s interest income for federal income tax purposes includes the amount of country X tax

that is imposed on *C* with respect to such interest income and that is paid on *C*'s behalf by *A* pursuant to the loan agreement. Under paragraph (f)(2)(i) of this section, such tax is considered for purposes of section 903 to be paid by *C*. No such tax is considered paid by *B*.

Example 3. Country X imposes a tax called the ''country X income tax.'' *A*, a United States person engaged in construction activities in country X, is subject to that tax. Country X has contracted with *A* for *A* to construct a naval base. *A* is a dual capacity taxpayer (as defined in paragraph (a)(2)(ii)(A) of this section) and, in accordance with paragraphs (a)(1) and (c)(1) of §1.901–2A, *A* has established that the country X income tax as applied to dual capacity persons and the country X income tax as applied to persons other than dual capacity persons together constitute a single levy. *A* has also established that that levy is an income tax within the meaning of paragraph (a)(1) of this section. Pursuant to the terms of the contract, country X has agreed to assume any country X tax liability that *A* may incur with respect to *A*'s income from the contract. For federal income tax purposes, *A*'s income from the contract includes the amount of tax liability that is imposed by country X on *A* with respect to its income from the contract and that is assumed by country X; and for purposes of section 901 the amount of such tax liability assumed by country X is considered to be paid by *A*. By reason of paragraph (f)(2)(i) of this section, country X is not considered to provide a subsidy, within the meaning of paragraph (e)(3) of this section, to *A*.

(3) *Taxes imposed on combined income of two or more persons*—(i) *In general.* If foreign tax is imposed on the combined income of two or more persons (for example, a husband and wife or a corporation and one or more of its subsidiaries), foreign law is considered to impose legal liability on each such person for the amount of the tax that is attributable to such person's portion of the base of the tax. Therefore, if foreign tax is imposed on the combined income of two or more persons, such tax is allocated among, and considered paid by, such persons on a pro rata basis in proportion to each person's portion of the combined income, as determined under foreign law and paragraph (f)(3)(iii) of this section. Combined income with respect to each foreign tax that is imposed on a combined basis is computed separately, and the tax on that combined income is allocated separately under this paragraph (f)(3)(i). If foreign law exempts from tax, or provides for specific rates of tax with respect to, certain types of income, or if certain expenses, deductions or credits are taken into account only with respect to a particular type of income, combined income with respect to such portions of the combined income is also computed separately, and the tax on that combined income is allocated separately under this paragraph (f)(3)(i). The rules of this paragraph (f)(3) apply regardless of which person is obligated to remit the tax, which person actually remits the tax, or which person the foreign country could proceed against to collect the tax in the event all or a portion of the tax is not paid. For purposes of this paragraph (f)(3), the term *person* means an individual or an entity (including a disregarded entity described in §301.7701–2(c)(2)(i) of this chapter) that is subject to tax in a foreign country as a corporation (or otherwise at the entity level). In determining the amount of tax paid by an owner of a partnership or a disregarded entity, this paragraph (f)(3) first applies to determine the amount of tax paid by the partnership or disregarded entity, and then paragraph (f)(4) of this section applies to allocate the amount of such tax to the owner.

(ii) *Combined income.* For purposes of this paragraph (f)(3), foreign tax is imposed on the combined income of two or more persons if such persons compute their taxable income on a combined basis under foreign law and foreign tax would otherwise be imposed on each such person on its separate taxable income. For example, income is computed on a combined basis if two or more persons add their items of income, gain, deduction, and loss to compute a single consolidated taxable income amount for foreign tax purposes. Foreign tax is considered to be imposed on the combined income of two or more persons even if the combined income is computed under foreign law by attributing to one such person (for example, the foreign parent of a foreign consolidated group) the income of other such persons or by treating persons that would otherwise be subject to tax as separate entities as unincorporated branches of a single corporation for

purposes of computing the foreign tax on the combined income of the group. However, foreign tax is not considered to be imposed on the combined income of two or more persons if, because one or more persons is a fiscally transparent entity (under the principles of §1.894–1(d)(3)) under foreign law, only one of such persons is subject to tax under foreign law (even if two or more of such persons are corporations for U.S. Federal income tax purposes). Therefore, foreign tax is not considered to be imposed on the combined income of two or more persons solely because foreign law:

(A) Permits one person to surrender a loss to another person pursuant to a group relief or other loss-sharing regime described in §1.909–2T(b)(2)(vi);

(B) Requires a shareholder of a corporation to include in income amounts attributable to taxes imposed on the corporation with respect to distributed earnings, pursuant to an integrated tax system that allows the shareholder a credit for such taxes;

(C) Requires a shareholder to include, pursuant to an anti-deferral regime (similar to subpart F of the Internal Revenue Code (sections 951 through 965)), income attributable to the shareholder's interest in the corporation;

(D) Reallocates income from one person to a related person under foreign transfer pricing rules;

(E) Requires a person to take into account a distributive share of income of an entity that is a partnership or other fiscally transparent entity for foreign tax law purposes; or

(F) Requires a person to take all or part of the income of an entity that is a corporation for U.S. Federal income tax purposes into account because foreign law treats the entity as a branch or fiscally transparent entity (a reverse hybrid). A reverse hybrid does not include an entity that is treated under foreign law as a branch or fiscally transparent entity solely for purposes of calculating combined income of a foreign consolidated group.

(iii) *Portion of combined income*—(A) *In general*. Each person's portion of the combined income is determined by reference to any return, schedule or other document that must be filed or maintained with respect to a person showing such person's income for foreign tax purposes, as properly amended or adjusted for foreign tax purposes. If no such return, schedule or other document must be filed or maintained with respect to a person for foreign tax purposes, then, for purposes of this paragraph (f)(3), such person's income is determined from the books of account regularly maintained by or on behalf of the person for purposes of computing its income for foreign tax purposes. Each person's portion of the combined income is determined by adjusting such person's income determined under this paragraph (f)(3)(iii)(A) as provided in paragraph (f)(3)(iii)(B) and (f)(3)(iii)(C) of this section.

(B) *Effect of certain payments*—(*1*) Each person's portion of the combined income is determined by giving effect to payments and accrued amounts of interest, rents, royalties, and other amounts between persons whose income is included in the combined base to the extent such amounts would be taken into account in computing the separate taxable incomes of such persons under foreign law if they did not compute their income on a combined basis. Each person's portion of the combined income is determined without taking into account any payments from other persons whose income is included in the combined base that are treated as dividends or other non-deductible distributions with respect to equity under foreign law, and without taking into account deemed dividends or any similar attribution of income made for purposes of computing the combined income under foreign law, regardless of whether any such deemed dividend or attribution of income results in a deduction or inclusion under foreign law.

(*2*) For purposes of determining each person's portion of the combined income, the treatment of a payment is determined under foreign law. Thus, for example, interest accrued by one group member with respect to an instrument held by another member that is treated as debt for foreign tax purposes but as equity for U.S. Federal income tax purposes would be considered income of the holder and would reduce the income of the issuer. See also §1.909–2T(b)(3)(i) for rules requiring

suspension of foreign income taxes paid or accrued by the owner of a U.S. equity hybrid instrument.

(C) *Net losses.* If tax is considered to be imposed on the combined income of three or more persons and one or more of such persons has a net loss for the taxable year for foreign tax purposes, the following rules apply. If foreign law provides mandatory rules for allocating the net loss among the other persons, then the rules that apply for foreign tax purposes apply for purposes of this paragraph (f)(3). If foreign law does not provide mandatory rules for allocating the net loss, the net loss is allocated among all other such persons on a pro rata basis in proportion to the amount of each person's income, as determined under paragraphs (f)(3)(iii)(A) and (f)(3)(iii)(B) of this section. For purposes of this paragraph (f)(3)(iii)(C), foreign law is not considered to provide mandatory rules for allocating a net loss solely because such loss is attributed from one person to a second person for purposes of computing combined income, as described in paragraph (f)(3)(ii) of this section.

(iv) *Collateral consequences.* U.S. tax principles apply to determine the tax consequences if one person remits a tax that is the legal liability of, and thus is considered paid by, another person.

(4) *Taxes imposed on partnerships and disregarded entities*—(i) *Partnerships.* If foreign law imposes tax at the entity level on the income of a partnership, the partnership is considered to be legally liable for such tax under foreign law and therefore is considered to pay the tax for U.S. Federal income tax purposes. The rules of this paragraph (f)(4)(i) apply regardless of which person is obligated to remit the tax, which person actually remits the tax, or which person the foreign country could proceed against to collect the tax in the event all or a portion of the tax is not paid. See §§ 1.702–1(a)(6) and 1.704–1(b)(4)(viii) for rules relating to the determination of a partner's distributive share of such tax. If the U.S. taxable year of a partnership closes for all partners due to a termination of the partnership under section 708(b)(1)(A) and the regulations under that section and the foreign taxable year of the partnership does not close, then foreign tax paid or accrued with respect to the foreign taxable year in which the termination occurs is allocated between the terminating partnership and its successors or assigns. For example, if, as a result of a change in ownership during a partnership's foreign taxable year, the partnership becomes a disregarded entity and the entity's foreign taxable year does not close, foreign tax paid or accrued by the owner of the disregarded entity with respect to the foreign taxable year is allocated between the partnership and the owner of the disregarded entity. If the U.S. taxable year of a partnership closes for all partners due to a termination of the partnership under section 708(b)(1)(B) and the regulations under that section and the foreign taxable year of the partnership does not close, then foreign tax paid or accrued by the new partnership with respect to the foreign taxable year in which the termination occurs is allocated between the terminating partnership and the new partnership. If multiple terminations under section 708(b)(1)(B) occur within the foreign taxable year, foreign tax paid or accrued with respect to that foreign taxable year by a new partnership is allocated among all terminating and new partnerships. In the case of any termination under section 708(b)(1), the allocation of foreign tax is made based on the respective portions of the taxable income (as determined under foreign law) for the foreign taxable year that are attributable under the principles of § 1.1502–76(b) to the period of existence of each terminating and new partnership, or successor or assign of a terminating partnership, during the foreign taxable year. Foreign tax allocated to a terminating partnership under this paragraph (f)(4)(i) is treated as paid or accrued by such partnership as of the close of the last day of its final U.S. taxable year. In the case of a change in any partner's interest in the partnership (a variance), except as otherwise provided in section 706(d)(2) (relating to certain cash basis items) or 706(d)(3) (relating to tiered partnerships), foreign tax paid or accrued by the partnership during its U.S. taxable year in which the variance occurs is allocated between the portion of the U.S. taxable year ending on, and the portion of the

U.S. taxable year beginning on the day after, the day of the variance. The allocation is made under the principles of this paragraph (f)(4)(i) as if the variance were a termination under section 708(b)(1).

(ii) *Disregarded entities.* If foreign law imposes tax at the entity level on the income of an entity described in § 301.7701–2(c)(2)(i) of this chapter (a *disregarded entity*), the person (as defined in section 7701(a)(1)) who is treated as owning the assets of the disregarded entity for U.S. Federal income tax purposes is considered to be legally liable for such tax under foreign law. Such person is considered to pay the tax for U.S. Federal income tax purposes. The rules of this paragraph (f)(4)(ii) apply regardless of which person is obligated to remit the tax, which person actually remits the tax, or which person the foreign country could proceed against to collect the tax in the event all or a portion of the tax is not paid. If there is a change in the ownership of such disregarded entity during the entity's foreign taxable year and such change does not result in a closing of the disregarded entity's foreign taxable year, foreign tax paid or accrued with respect to such foreign taxable year is allocated between the transferor and the transferee. If there is more than one change in the ownership of a disregarded entity during the entity's foreign taxable year, foreign tax paid or accrued with respect to that foreign taxable year is allocated among all transferors and transferees. The allocation is made based on the respective portions of the taxable income of the disregarded entity (as determined under foreign law) for the foreign taxable year that are attributable under the principles of § 1.1502–76(b) to the period of ownership of each transferor and transferee during the foreign taxable year. If, as a result of a change in ownership, the disregarded entity becomes a partnership and the entity's foreign taxable year does not close, foreign tax paid or accrued by the partnership with respect to the foreign taxable year is allocated between the owner of the disregarded entity and the partnership under the principles of this paragraph (f)(4)(ii). If the person who owns a disregarded entity is a partnership for U.S. Federal income tax purposes, see § 1.704–1(b)(4)(viii) for rules relating to the allocation of such tax among the partners of the partnership.

(5) *Allocation of foreign taxes in connection with elections under section 336(e) or 338.* For rules relating to the allocation of foreign taxes in connection with elections made pursuant to section 336(e), see § 1.336–2(g)(3)(ii). For rules relating to the allocation of foreign taxes in connection with elections made pursuant to section 338, see § 1.338–9(d).

(6) *Examples.* The following examples illustrate the rules of paragraphs (f)(3) and (f)(4) of this section:

Example 1. (i) *Facts.* A, a United States person, owns 100 percent of B, an entity organized in country X. B owns 100 percent of C, also an entity organized in country X. B and C are corporations for U.S. and foreign tax purposes that use the ''u'' as their functional currency. Pursuant to a consolidation regime, country X imposes an income tax described in (a)(1) of this section on the combined income of B and C within the meaning of paragraph (f)(3)(ii) of this section. In year 1, C pays 25u of interest to B. If B and C did not report their income on a combined basis for country X tax purposes, the interest paid from C to B would result in 25u of interest income to B and 25u of deductible interest expense to C. For purposes of reporting the combined income of B and C, country X first requires B and C to determine their own income (or loss) on a separate schedule. For this purpose, however, neither B nor C takes into account the 25u of interest paid from C to B because the income of B and C is included in the same combined base. The separate income of B and C reported on their country X schedules for year 1, which do not reflect the 25u intercompany payment, is 100u and 200u, respectively. The combined income reported for country X purposes is 300u (the sum of the 100u separate income of B and 200u separate income of C).

(ii) *Result.* On the separate schedules described in paragraph (f)(3)(iii)(A) of this section, B's separate income is 100u and C's separate income is 200u. Under paragraph (f)(3)(iii)(B)(*1*) of this section, the 25u interest payment from C to B is taken into account for purposes of determining B's and C's portions of the combined income under paragraph (f)(3)(iii) of this section, because B and C would have taken the items into account if they did not compute their income on a combined basis. Thus, B's portion of the combined income is 125u (100u plus 25u) and C's portion of the combined income is 175u (200u less 25u). The result is the same regardless of whether the 25u interest payment from C to B is deductible for U.S. Federal income tax

purposes. See paragraph (f)(3)(iii)(B)(*2*) of this section.

Example 2. (i) *Facts.* A, a United States person, owns 100 percent of B, an entity organized in country X. B is a corporation for country X tax purposes, and a disregarded entity for U.S. income tax purposes. B owns 100 percent of C and D, entities organized in country X that are corporations for both U.S. and country X tax purposes. B, C, and D use the ''u'' as their functional currency and file on a combined basis for country X income tax purposes. Country X imposes an income tax described in paragraph (a)(1) of this section at the rate of 30 percent on the taxable income of corporations organized in country X. Under the country X combined reporting regime, income (or loss) of C and D is attributed to, and treated as income (or loss) of, B. B has the sole obligation to pay country X income tax imposed with respect to income of B and income of C and D that is attributed to, and treated as income of, B. Under the law of country X, country X may proceed against B, but not C or D, if B fails to pay over to country X all or any portion of the country X income tax imposed with respect to such income. In year 1, B has income of 100u, C has income of 200u, and D has a net loss of (60u). Under the law of country X, B is considered to have 240u of taxable income with respect to which 72u of country X income tax is imposed. Country X does not provide mandatory rules for allocating D's loss.

(ii) *Result.* Under paragraph (f)(3)(ii) of this section, the 72u of country X tax is considered to be imposed on the combined income of B, C, and D. Because country X law does not provide mandatory rules for allocating D's loss between B and C, under paragraph (f)(3)(iii)(C) of this section D's (60u) loss is allocated pro rata: 20u to B ((100u/300u) × 60u) and 40u to C ((200u/300u) × 60u). Under paragraph (f)(3)(i) of this section, the 72u of country X tax must be allocated pro rata among B, C, and D. Because D has no income for country X tax purposes, no country X tax is allocated to D. Accordingly, 24u (72u × (80u/240u)) of the country X tax is allocated to B, and 48u (72u × (160u/240u)) of such tax is allocated to C. Under paragraph (f)(4)(ii) of this section, A is considered to have legal liability for the 24u of country X tax allocated to B under paragraph (f)(3) of this section.

Example 3. (i) *Facts.* A, B, and C are U.S. persons that each use the calendar year as their taxable year. A and B each own 50 percent of the capital and profits of D, an entity organized in country M. D is a partnership for U.S. tax purposes, but is a corporation for country M tax purposes. D uses the ''u'' as its functional currency and the calendar year as its taxable year for both U.S. tax purposes and country M tax purposes. Country M imposes an income tax described in paragraph (a)(1) of this section at a rate of 30 percent at the entity level on the taxable income of D. On September 30 of Year 1, A sells its 50 percent interest in D to C. A's sale of its partnership interest results in a termination of the partnership under section 708(b)(1)(B) for U.S. tax purposes. As a result of the termination, ''old'' D's taxable year closes on September 30 of Year 1 for U.S. tax purposes. New D also has a short U.S. taxable year, beginning on October 1 and ending on December 31 of Year 1. The sale of A's interest does not close D's taxable year for country M tax purposes. D has 400u of taxable income for its foreign taxable year ending December 31, Year 1 with respect to which country M imposes 120u of income tax, equal to $120 as translated in accordance with section 986(a).

(ii) *Result.* Under paragraph (f)(4)(i) of this section, partnership D is legally liable for the $120 of country M income tax imposed on its foreign taxable income. Because D's taxable year closes on September 30, Year 1, for U.S. tax purposes, but does not close for country M tax purposes, under paragraph (f)(4)(i) of this section the $120 of country M tax must be allocated under the principles of § 1.1502–76(b) between terminating D and new D. See § 1.704–1(b)(4)(viii) for rules relating to the allocation of terminating D's country M taxes between A and B and the allocation of new D's country M taxes between B and C.

(g) *Definitions.* For purposes of this section and §§ 1.901–2A and 1.903–1, the following definitions apply:

(1) The term *paid* means ''paid or accrued''; the term *payment* means ''payment or accrual''; and the term *paid by* means ''paid or accrued by or on behalf of.''

(2) The term *foreign country* means any foreign state, any possession of the United States, and any political subdivision of any foreign state or of any possession of the United States. The term ''possession of the United States'' includes Puerto Rico, the Virgin Islands, Guam, the Northern Mariana Islands and American Samoa.

(3) The term *foreign levy* means a levy imposed by a foreign country.

(h) *Effective/applicability date*—(1) *In general.* This section and §§ 1.901–2A and 1.903–1 apply to taxable years beginning after November 14, 1983.

(2) Except as provided in paragraph (h)(3) of this section, paragraph (e)(5)(iv) of this section applies to foreign payments that, if such payments were an amount of tax paid, would be considered paid or accrued under § 1.901–2(f) on or after July 13, 2011. See 26 CFR 1.901–2T(e)(5)(iv) (revised as of

April 1, 2011), for rules applicable to foreign payments that, if such payments were an amount of tax paid, would be considered paid or accrued before July 13, 2011.

(3) The last sentence of paragraph (e)(5)(iv)(B)(*1*)(*ii*) of this section applies to foreign payments that, if such payments were an amount of tax paid, would be considered paid or accrued under § 1.901–2(f) on or after September 4, 2013. See 26 CFR 1.901–2T(e)(5)(iv)(B)(*1*)(*iii*) (revised as of April 1, 2013) for rules applicable to foreign payments that, if such payments were an amount of tax paid, would be considered paid or accrued under § 1.901–2(f) before September 4, 2013.

(4) Paragraphs (f)(3), (f)(4), and (f)(6) of this section apply to foreign taxes paid or accrued in taxable years beginning after February 14, 2012. However, if an amount of tax is paid or accrued in a taxable year of any person beginning on or before February 14, 2012, and the tax is treated as paid or accrued by such person under 26 CFR 1.901–2(f) (revised as of April 1, 2011), then paragraph (f)(4) of this section will not apply, and 26 CFR 1.901–2(f) (revised as of April 1, 2011) will apply, to determine the person with legal liability for that tax. No other person will be treated as legally liable for such tax, even if the tax is paid or accrued on a date that falls within a taxable year of such other person beginning after February 14, 2012. Taxpayers may choose to apply paragraph (f)(3) of this section to foreign taxes paid or accrued in taxable years beginning after December 31, 2010, and on or before February 14, 2012.

(Approved by the Office of Management and Budget under control number 1545–0746)

[T.D. 7918, 48 FR 46276, Oct. 12, 1983, as amended by T.D. 8372, 56 FR 56008, Oct. 31, 1991; T.D. 9416, 73 FR 40733, July 16, 2008; T.D. 9536, 76 FR 42037, July 18, 2011, T.D. 9535, 76 FR 42043, July 18, 2011; T.D. 9536, 76 FR 53819, Aug. 30, 2011; T.D. 9576, 77 FR 8125, Feb. 14, 2012; T.D. 9619, 78 FR 28489, May 15, 2013; T.D. 9634, 78 FR 54391, Sept. 4, 2013]

§ 1.901–2A Dual capacity taxpayers.

(a) *Application of separate levy rules as applied to dual capacity taxpayers*—(1) *In general.* If the application of a foreign levy (as defined in § 1.901–2(g)(3)) is different, either by the terms of the levy or in practice, for dual capacity taxpayers (as defined in § 1.901–2(a)(2)(ii)(A)) from its application to other persons, then, unless the only such difference is that a lower rate (but the same base) applies to dual capacity taxpayers, such difference is considered to be related to the fact that dual capacity taxpayers receive, directly or indirectly, a specific economic benefit (as defined in § 1.901–2(a)(2)(ii)(B)) from the foreign country and thus to be a difference in kind, and not merely of degree. In such a case, notwithstanding any contrary provision of § 1.901–2(d), the levy as applicable to such dual capacity taxpayers is a separate levy (within the meaning of § 1.901–2(d)) from the levy as applicable to such other persons, regardless of whether such difference is in the base of the levy, in the rate of the levy, or both. In such a case, each of the levy as applied to dual capacity taxpayers and the levy as applied to other persons must be analyzed separately to determine whether it is an income tax within the meaning of § 1.901–2(a)(1) and whether it is a tax in lieu of an income tax within the meaning of § 1.903–1(a). However, if the application of the levy is neither different by its terms nor different in practice for dual capacity taxpayers from its application to other persons, or if the only difference is that a lower rate (but the same base) applies to dual capacity taxpayers, then, in accordance with § 1.901–2(d), such foreign levy as applicable to dual capacity taxpayers and such levy as applicable to other persons together constitute a single levy. In such a case, no amount paid (as defined in § 1.901–2(g)(1)) pursuant to such levy by any such dual capacity taxpayer is considered to be paid in exchange for a specific economic benefit, and such levy, as applicable in the aggregate to such dual capacity taxpayers and to such other persons, is analyzed to determine whether it is an income tax within the meaning of § 1.901–2(a)(1) or a tax in lieu of an income tax within the meaning of § 1.903–1(a). Application of a foreign levy to dual capacity taxpayers will be considered to be different in practice from application of that levy to other persons, even if no such difference is apparent from the terms of the levy, unless it is

established that application of that levy to dual capacity taxpayers does not differ in practice from its application to other persons.

(2) *Examples*. The provisions of paragraph (a)(1) of this section may be illustrated by the following examples:

Example 1. Under a levy of country X called the country X income tax, every corporation that does business in country X is required to pay to country X 40 percent of its income from its business in country X. Income for purposes of the country X income tax is computed by subtracting specified deductions from the corporation's gross income derived from its business in country X. The specified deductions include the corporation's expenses attributable to such gross income and allowances for recovery of the cost of capital expenditures attributable to such gross income, except that under the terms of the country X income tax a corporation engaged in the exploitation of minerals K, L or M in country X is not permitted to recover, currently or in the future, expenditures it incurs in exploring for those minerals. In practice, the only corporations that engage in exploitation of the specified minerals in country X are dual capacity taxpayers. Thus, the application of the country X income tax to dual capacity taxpayers is different from its application to other corporations. The country X income tax as applied to corporations that engage in the exploitation of minerals K, L or M (dual capacity taxpayers) is, therefore, a separate levy from the country X income tax as applied to other corporations. Accordingly, each of (i) the country X income tax as applied to such dual capacity taxpayers and (ii) the country X income tax as applied to such other persons, must be analyzed separately to determine whether it is an income tax within the meaning of §1.901–2(a)(1) and whether it is a tax in lieu of an income tax within the meaning of §1.903–1(a).

Example 2. The facts are the same as in example 1, except that it is demonstrated that corporations that engage in exploitation of the specified minerals in country X and that are subject to the levy include both dual capacity taxpayers and other persons. The country X income tax as applied to all corporations is, therefore, a single levy. Accordingly, no amount paid pursuant to the country X income tax by a dual capacity taxpayer is considered to be paid in exchange for a specific economic benefit; and, if the country X income tax is an income tax within the meaning of §1.901–2(a)(1) or a tax in lieu of an income tax within the meaning of §1.903–1(a), it will be so considered in its entirety for all corporations subject to it.

Example 3. Under a levy of country Y called the country Y income tax, each corporation incorporated in country Y is required to pay to country Y a percentage of its worldwide income. The applicable percentage is greater for such corporations that earn more than a specified amount of income than for such corporations that earn less than that amount. Income for purposes of the levy is computed by deducting from gross income specified types of expenses and specified allowances for capital expenditures. The expenses for which deductions are permitted differ depending on the type of business in which the corporation subject to the levy is engaged, *e.g.*, a deduction for interest paid to a related party is not allowed for corporations engaged in enumerated types of activities. In addition, carryover of losses from one taxable period to another is permitted for corporations engaged in specified types of activities, but not for corporations engaged in other activities. By its terms, the foreign levy makes no distinction between dual capacity taxpayers and other persons. It is established that in practice the higher rate of the country Y income tax applies to both dual capacity taxpayers and other persons and that in practice the differences in the base of the country Y income tax (*e.g.*, the lack of a deduction for interest paid to related parties for some corporations subject to the levy and the lack of a carryover provision for some corporations subject to the levy) apply to both dual capacity taxpayers and other persons. The country Y income tax as applied to all corporations incorporated in country Y is therefore a single levy. Accordingly, no amount paid pursuant to the country Y income tax by a dual capacity taxpayer is considered to be paid in exchange for a specific economic benefit; and if the country Y income tax is an income tax within the meaning of §1.901–2(a)(1) or a tax in lieu of an income tax within the meaning of §1.903–1(a), it will be so considered in its entirety for all persons subject to it.

Example 4. The facts are the same as in example 3, except that it is not established that in practice the higher rate does not apply only to dual capacity taxpayers. By reason of such higher rate, application of the country Y income tax to dual capacity taxpayers is different in practice from application of the country Y income tax to other persons subject to it. The country Y income tax as applied to dual capacity taxpayers is therefore a separate levy from the country Y income tax as applied to other corporations incorporated in country Y. Accordingly, each of (i) the country Y income tax as applied to dual capacity taxpayers and (ii) the country Y income tax as applied to other corporations incorporated in country Y, must be analyzed separately to determine whether it is an income tax within the meaning of §1.901–2(a)(1) and whether it is a tax in lieu of an income tax within the meaning of §1.903–1(a).

Example 5. Under a levy of country X called the country X tax, all persons who do not engage in business in country X and who receive interest income from residents of country X are required to pay to country X 25 percent of the gross amount of such interest income. It is established that the country X tax applies by its terms and in practice to certain banks that are dual capacity taxpayers and to persons who are not dual capacity taxpayers and that application to such dual capacity taxpayers does not differ by its terms or in practice from application to such other persons. The country X tax as applied to all such persons (both the dual capacity taxpayers and the other persons) is, therefore, a single levy. Accordingly, no amount paid pursuant to the country X tax by such a dual capacity taxpayer is considered to be paid in exchange for a specific economic benefit; and, if the country X tax is a tax in lieu of an income tax within the meaning of §1.903–1(a), it will be so considered in its entirety for all persons subject to it.

Example 6. Under a levy of country X called the country X tax, every corporation incorporated outside of country X (''foreign corporation'') that maintains a branch in country X is required annually to pay to country X 52 percent of its net income attributable to that branch. It is established that the application of the country X tax is neither different by its terms nor different in practice for certain banks that are dual capacity taxpayers from its application to persons (which may, but do not necessarily, include other banks) that are not dual capacity taxpayers. The country X tax as applied to all foreign corporations with branches in country X (*i.e.,* both those banks that are dual capacity taxpayers and the foreign corporations that are not dual capacity taxpayers) is, therefore, a single levy. Accordingly, no amount paid pursuant to the country X tax by a bank that is a dual capacity taxpayer is considered to be paid in exchange for a specific economic benefit; and, if the country X tax is an income tax within the meaning of §1.901–2(a)(1) or a tax in lieu of an income tax within the meaning of §1.903–1(a), it will be so considered in its entirety for all persons subject to it.

Example 7. Under a levy of country H called the country H tax, all corporations that are organized outside country H and that do not engage in business in country H are required to pay to country H a percentage of the gross amount of interest income derived from residents of country H. The percentage is 30 percent, except that it is 15 percent for a specified category of corporations. All corporations in that category are dual capacity taxpayers. It is established that the country H tax applies by its terms and in practice to dual capacity taxpayers and to persons that are not dual capacity taxpayers and that the only difference in application between such dual capacity taxpayers and such other persons is that a lower rate (but the same base) applies to such dual capacity taxpayers. The country H tax as applied to all such persons (both the dual capacity taxpayers and the other persons) is, therefore, a single levy. Accordingly, no amount paid pursuant to the country H tax by such a dual capacity taxpayer is considered to be paid in exchange for a specific economic benefit, and if the country H tax is a tax in lieu of an income tax within the meaning of §1.903–1(a), it will be so considered in its entirety for all persons subject to it.

(b) *Burden of proof for dual capacity taxpayers*—(1) *In general.* For credit to be allowable under section 901 or 903, the person claiming credit must establish that the foreign levy with respect to which credit is claimed is an income tax within the meaning of §1.901–2(a)(1) or a tax in lieu of an income tax within the meaning of §1.903–1(a), respectively. Thus, such person must establish, among other things, that such levy is a tax. See §1.901–2(a)(2)(i) and §1.903–1(a). Where a person claims credit under section 901 or 903 for an amount paid by a dual capacity taxpayer pursuant to a foreign levy, §1.901–2(a)(2)(i) and §1.903–1(a), respectively, require such person to establish the amount, if any, that is paid pursuant to the distinct element of the levy that is a tax. If, pursuant to paragraph (a)(1) of this section and §1.901–2(d), such levy as applicable to dual capacity taxpayers and such levy as applicable to other persons together constitute a single levy, then no amount paid pursuant to that levy by any such dual capacity taxpayer is considered to be paid in exchange for a specific economic benefit. Accordingly, such levy has only one distinct element, and the levy either is or is not, in its entirety, a tax. If, however, such levy as applicable to dual capacity taxpayers is a separate levy from such levy as applicable to other persons, then a person claiming credit under section 901 or 903 for an amount paid by a dual capacity taxpayer pursuant to such separate levy may establish the amount, if any, that is paid pursuant to the distinct element of the levy that is a tax only by the facts and circumstances method or the safe harbor method described in paragraph (c) of this section. If such

person fails to so establish such amount, no portion of the amount that is paid pursuant to the separate levy by the dual capacity taxpayer to such foreign country shall be treated as an amount of tax. Any amount that, either by reason of application of the methods of paragraph (c) of this section or by reason of the immediately preceding sentence, is not treated as an amount of tax shall (i) be considered to have been paid in exchange for a specific economic benefit; (ii) be characterized (*e.g.*, as royalty, purchase price, cost of sales, reduction of the proceeds of a sale, or reduction of interest income) according to the nature of the transaction and of the specific economic benefit received; and (iii) be treated according to such characterization for all purposes of chapter 1 of the Internal Revenue Code, except that any determination that an amount is not tax for purposes of section 901 or 903 by reason of application of the safe harbor method shall not be taken into account in determining whether or not such an amount is to be characterized and treated as tax for purposes of computing an allowance for percentage depletion under sections 611 and 613.

(2) *Effect of certain treaties.* If, irrespective of whether such credit would be allowable under section 901 or 903 in the absence of a treaty, the United States has in force a treaty with a foreign country that treats a foreign levy as an income tax for purposes of allowing credit for United States tax and if the person claiming credit is entitled to the benefit of such treaty, then, unless such person claims credit not under the treaty but under section 901 or 903, and except to the extent the treaty provides otherwise and subject to all terms, conditions and limitations provided in the treaty, no portion of an amount paid with respect to such levy by a dual capacity taxpayer shall be considered to be paid in exchange for a specific economic benefit. If, however, such person claims credit not under such treaty but rather under section 901 or 903 (*e.g.*, so as not to be subject to a limitation contained in such treaty), the provisions of this section apply to such levy.

(c) *Satisfaction of burden of proof*—(1) *In general.* This paragraph (c) sets out the methods by which a person who claims credit under section 901 or 903 for an amount paid by a dual capacity taxpayer pursuant to a foreign levy that satisfies all of the criteria of section 901 or 903 other than the determination of the distinct element of the levy that is a tax and of the amount that is paid pursuant to that distinct element (a ''qualifying levy'') may establish such distinct element and amount. Such person must establish the amount paid pursuant to a qualifying levy that is paid pursuant to the distinct element of the levy that is a tax (which amount therefore is an amount of income tax within the meaning of §1.901–2(a)(1) or an amount of tax in lieu of income tax within the meaning of §1.903–1(a) (a ''qualifying amount'')) only by the facts and circumstances method set forth in paragraph (c)(2) of this section or the safe harbor method set forth in paragraph (c)(3) of this section. A levy is not a qualifying levy, and neither the facts and circumstances method nor the safe harbor method applies to an amount paid by a dual capacity taxpayer pursuant to a foreign levy, if it has been established pursuant to §1.901–2(d) and paragraph (a)(1) of this section that that levy as applied to that dual capacity taxpayer and that levy as applied to persons other than dual capacity taxpayers together constitute a single levy, or if it has been established in accordance with the first sentence of paragraph (b)(2) of this section that credit is allowable by reason of a treaty for an amount paid with respect to such levy.

(2) *Facts and circumstances method*—(i) *In general.* If the person claiming credit establishes, based on all of the relevant facts and circumstances, the amount, if any, paid by the dual capacity taxpayer pursuant to the qualifying levy that is not paid in exchange for a specific economic benefit, such amount is the qualifying amount with respect to such qualifying levy. In determining the qualifying amount with respect to a qualifying levy under the facts and circumstances method, neither the methodology nor the results that would have obtained if a person had elected to apply the safe harbor method to such qualifying levy is a relevant

fact or circumstance. Accordingly, neither such methodology nor such results shall be taken into account in applying the facts and circumstances method.

(ii) *Examples*. The application of the facts and circumstances method is illustrated by the following examples:

Example 1. Country A, which does not have a generally imposed income tax, imposes a levy, called the country A income tax, on corporations that carry on the banking business through a branch in country A. All such corporations lend money to the government of country A, and the consideration (interest) paid by the government of country A for the loans is not made available by the government on substantially the same terms to the population of country A in general. Thus, the country A income tax is imposed only on dual capacity taxpayers. *L*, a corporation that carries on the banking business through a branch in country A and that is a dual capacity taxpayer, establishes that all of the criteria of section 901 are satisfied by the country A income tax, except for the determination of the distinct element of the levy that is a tax and of *L*'s qualifying amount with respect thereto. The country A income tax is, therefore, a qualifying levy. *L* establishes that, although all persons subject to the country A income tax are dual capacity taxpayers, the country A income tax applies in the same manner to income from such persons' transactions with the government of country A as it does to income from their transactions with private persons; that there are significant transactions (either in volume or in amount) with private persons; and that the portion of such persons' income that is derived from transactions with the government of country A on the one hand or private persons on the other varies greatly among persons subject to the country A income tax. By making this showing, *L* has demonstrated that no portion of the amount paid by it to country A pursuant to the levy is paid in exchange for a specific economic benefit (the interest income). Accordingly, *L* has demonstrated under the facts and circumstances method that the entire amount it has paid pursuant to the country A income tax is a qualifying amount.

Example 2. *A*, a domestic corporation that is a dual capacity taxpayer subject to a qualifying levy of country X, pays 1000u (units of country X currency) to country X in 1986 pursuant to the qualifying levy. *A* does not elect to apply the safe harbor method to country X, but if it had so elected, 800u would have been *A's* qualifying amount with respect to the levy. Based on all of the relevant facts and circumstances (which do not include either the methodology of the safe harbor method or the qualifying amount that would have obtained under that method), *A* establishes that 628u of such 1000u is not paid in exchange for a specific economic benefit. *A* has demonstrated under the facts and circumstances method that 628u is a qualifying amount. Pursuant to paragraph (b)(1) of this section, 372u (1000u–628u) is considered to have been paid by *A* in exchange for a specific economic benefit. That amount is characterized and treated as provided in paragraph (b)(1) of this section.

Example 3. The facts are the same as in example 2 except that under the safe harbor method 580u would have been *A*'s qualifying amount with respect to the levy. That amount is not a relevant fact or circumstance and the result is the same as in example 2.

(3) *Safe harbor method*. Under the safe harbor method, the person claiming credit makes an election as provided in paragraph (d) of this section and, pursuant to such election, applies the safe harbor formula described in paragraph (e) of this section to the qualifying levy or levies to which the election applies.

(d) *Election to use the safe harbor method*—(1) *Scope of election*. An election to use the safe harbor method is made with respect to one or more foreign states and possessions of the United States with respect to a taxable year of the person making the election (the ''electing person''). Such election applies to such taxable year and to all subsequent taxable years of the electing person (''election years''), unless the election is revoked in accordance with paragraph (d)(4) of this section. If an election applies to a foreign state or possession of the United States (''elected country''), it applies to all qualifying levies of the elected country and to all qualifying levies of all political subdivisions of the elected country with respect to which the electing person claims credit for amounts paid (or deemed to be paid) by any dual capacity taxpayer. A member of an affiliated group that files a consolidated United States income tax return may use the safe harbor method for a foreign state or U.S. possession only if an election to use the safe harbor method for that state or possession has been made by the common parent of such affiliated group on behalf of all members of the group. Similarly, a member of an affiliated group that does not file a consolidated United States income tax return

may elect to use the safe harbor method for a foreign state or U.S. possession only if an election to use the safe harbor method for that state or possession is made by each member of the affiliated group which claims credit for taxes paid to such state or possession or to any political subdivision thereof. An election to use the safe harbor method for an elected country does not apply to foreign taxes carried back or forward to any election year from any taxable year to which the election does not apply. Such election does apply to foreign taxes carried back or forward from any election year to any taxable year. A person who elects to use the safe harbor method for one or more foreign countries may, in a later taxable year, also elect to use that method for other foreign countries.

(2) *Effect of election.* An election to use the safe harbor method described in paragraph (c)(3) of this section requires the electing person to apply the safe harbor formula of paragraph (e) of this section to all qualifying levies of all elected countries and their political subdivisions, and constitutes a specific waiver by such person of the right to use the facts and circumstances method described in paragraph (c)(2) of this section with respect to any levy of any elected country or any political subdivision thereof.

(3) *Time and manner of making election*—(i) *In general.* To elect to use the safe harbor method, an electing person must attach a statement to its United States income tax return for the taxable year for which the election is made and must file such return by the due date (including extensions) for the filing thereof. Such statement shall state—

(A) That the electing person elects to use the safe harbor method for the foreign states and the possessions of the United States designated in the statement and their political subdivisions, and

(B) That the electing person waives the right, for any election year, to use the facts and circumstances method for any levy of the designated states, possessions and political subdivisions. Notwithstanding the foregoing, a person may, with the consent of the Commissioner, elect to use the safe harbor method for a taxable year for one or more foreign states or possessions of the United States, at a date later than that specified in the first sentence of this paragraph (d)(3)(i), *e.g.*, upon audit of such person's United States income tax return for such taxable year. The Commissioner will normally consent to such a later election if such person demonstrates that it failed to make a timely election for such a foreign state or possession for such taxable year because such person reasonably believed either that it was not a dual capacity taxpayer with respect to such state or possession or that no levy that it paid to such state or possession or any political subdivision thereof was a qualifying levy (for example, because it reasonably, but incorrectly, believed that the levy it paid was not a separate levy from that applicable to persons other than dual capacity taxpayers). The Commissioner will not, however, consent to such a later election with respect to any state or possession for a taxable year if such person (or any other member of an affiliated group of which such person is a member) applied the facts and circumstances method to any levy of such state or possession or any political subdivision thereof for such taxable year.

(ii) Certain retroactive elections. Notwithstanding the requirements of paragraph (d)(3)(i) of this section relating to the time and manner of making an election, an election may be made for a taxable year beginning on or before November 14, 1983, provided the electing person elects in accordance with § 1.901–2(h) to apply all of the provisions of this section, § 1.901–2 and § 1.903–1 to such taxable year and provided all of the requirements set forth in this paragraph (d)(3)(ii) are satisfied. Such an election shall be made by timely (including extensions) filing a federal income tax return or an amended federal income tax return for such taxable year; by attaching to such return a statement containing the statements and information set forth in paragraph (d)(3)(i) of this section; and by filing amended income tax returns for all subsequent election years for which income tax returns have previously been filed in which credit is

claimed under section 901 or 903 and applying the safe harbor method in such amended returns. All amended returns referred to in the immediately preceding sentence must be filed on or before October 12, 1984, (unless the Commissioner consents to a later filing in circumstances similar to those provided in paragraph (d)(3)(i)) and at a time when neither assessment of a deficiency for any of such election years nor the filing of a claim for any refund claimed in any such amended return is barred.

(iii) *Election to credit taxes made in amended return.* If a person has filed a United States income tax return for a taxable year to which this §1.901–2A applies (including application by reason of the election provided in §1.901–2(h)(2)) in which such person has deducted (instead of credited) qualifying foreign taxes and such person validly makes an election to credit (instead of deduct) such taxes in a timely filed amended return for such taxable year, an election to use the safe harbor method may be made in such amended return provided all of the requirements of paragraph (d)(3)(ii) of this section are satisfied other than the requirement that such amended return and the other amended returns referred to in that paragraph be filed on or before October 12, 1984.

(4) *Revocation of election.* An election to use the safe harbor method described in paragraph (c)(3) of this section may not be revoked without the consent of the Commissioner. An application for consent to revoke such election with respect to one or more elected countries shall be made to the Commissioner of Internal Revenue, Washington, DC 20224. Such application shall be made not later than the 30th day before the due date (including extensions) for the filing of the income tax return for the first taxable year for which the revocation is sought to be effective, except in the case of an event described in (i), (ii), (iii) or (iv) below, in which case an application for revocation with retroactive effect may be made within a reasonable time after such event. The Commissioner may make his consent to any revocation conditioned upon adjustments being made in one or more taxable years so as to prevent the revocation from resulting in a distortion of the amount of any item relating to tax liability in any taxable year. The Commissioner will normally consent to a revocation (including, in the case of (i), (ii), (iii) or (iv) below, one with retroactive effect), if—

(i) An amendment to the Internal Revenue Code or the regulations thereunder is made which applies to the taxable year for which the revocation is to be effective and the amendment substantially affects the taxation of income from sources outside the United States under subchapter N of chapter 1 of the Internal Revenue Code; or

(ii) After a safe harbor election is made with respect to a foreign state, a tax treaty between the United States and that state enters into force; that treaty covers a foreign tax to which the safe harbor election applies; and that treaty applies to the taxable year for which the revocation is to be effective; or

(iii) After a safe harbor election is made with respect to a foreign state or possession of the United States, a material change is made in the tax law of that state or possession or of a political subdivision of that state or possession; and the changed law applies to the taxable year for which the revocation is to be effective and has a material effect on the taxpayer; or

(iv) With respect to a foreign country to which a safe harbor election applies, the Internal Revenue Service issues a letter ruling to the electing person and that letter ruling (*A*) relates to the availability or application of the safe harbor method to one or more levies of such foreign country; (*B*) does not relate to the facts and circumstances method described in paragraph (c)(2) of this section; and (*C*) fails to include a ruling requested by the electing person or includes a ruling contrary to one requested by such person (in either case, other than one relating to the facts and circumstances method) and such failure or inclusion has a material adverse effect on the amount of such electing person's credit for taxes paid to such foreign country for the taxable year for which the revocation is to be effective; or

(v) A corporation (''new member'') becomes a member of an affiliated group; the new member and one or more pre-existing members of such group are dual capacity taxpayers with respect to the same foreign country; and, with respect to such country, either the new member or the pre-existing members (but not both) have made a safe harbor election; and the Commissioner in his discretion determines that obtaining the benefit of the right to revoke the safe harbor election with respect to such foreign country was not the principal purpose of the affiliation between such new member and such group; or

(vi) The election has been in effect with respect to at least three taxable years prior to the taxable year for which the revocation is to be effective.

The Commissioner may, in his discretion, consent to a revocation even if none of the foregoing subdivisions (i) through (vi) is applicable. If an election has been revoked with respect to an elected country, a subsequent election to apply the safe harbor method with respect to such elected country may be made only with the consent of the Commissioner and upon such terms and conditions as the Commissioner in his discretion may require.

(e) *Safe harbor formula*—(1) *In general.* The safe harbor formula applies to determine the distinct element of a qualifying levy that is a tax and the amount paid by a dual capacity taxpayer pursuant to such qualifying levy that is the qualifying amount with respect to such levy. Under the safe harbor formula the amount paid in a taxable year pursuant to a qualifying levy that is the qualifying amount with respect to such levy is an amount equal to:

$$(A - B - C) \times D / (1 - D)$$

where (except as otherwise provided in paragraph (e)(5) of this section):

A = the amount of gross receipts as determined under paragraph (e)(2) of this section

B = the amount of costs and expenses as determined under paragraph (e)(2) of this section

C = the total amount paid in the taxable year by the dual capacity taxpayer pursuant to the qualifying levy (the ''actual payment amount'')

D = the tax rate as determined under paragraph (e)(3) of this section

In no case, however, shall the qualifying amount exceed the actual payment amount; and the qualifying amount is zero if the safe harbor formula yields a qualifying amount less than zero. The safe harbor formula is intended to yield a qualifying amount that is approximately equal to the amount of generally imposed income tax within the meaning of paragraphs (a) and (b)(1) of § 1.903–1 (''general tax'') of the foreign country that would have been required to be paid in the taxable year by the dual capacity taxpayer if it had not been a dual capacity taxpayer and if the base of the general tax had allowed a deduction in such year for the amount (''specific economic benefit amount'') by which the actual payment amount exceeds the qualifying amount. See, however, paragraph (e)(5) of this section if an elected country has no general tax. The specific economic benefit amount is considered to be the portion of the actual payment amount that is paid pursuant to the distinct portion of the qualifying levy that imposes an obligation in exchange for a specific economic benefit. The specific economic benefit amount is therefore considered to be an amount paid by the dual capacity taxpayer in exchange for such specific economic benefit, which amount must be treated for purposes of chapter 1 of the Internal Revenue Code as provided in paragraph (b)(1) of this section.

(2) *Determination of gross receipts and costs and expenses.* For purposes of the safe harbor formula, gross receipts and costs and expenses are, except as otherwise provided in this paragraph (e), the gross receipts and the deductions for costs and expenses, respectively, as determined under the foreign law applicable in computing the actual payment amount of the qualifying levy to which the safe harbor formula applies. However, except as otherwise provided in this paragraph (e), if provisions of the qualifying levy increase or decrease the liability imposed on dual capacity taxpayers compared to the general tax

liability of persons other than dual capacity taxpayers by reason of the determination or treatment of gross receipts or of costs or expenses, the provisions generally applicable in computing such other persons' tax base under the general tax shall apply to determine gross receipts and costs and expenses for purposes of computing the qualifying amount. If provisions of the qualifying levy relating to gross receipts meet the requirements of § 1.901–2(b) (3)(i), such provisions shall apply to determine gross receipts for purposes of computing the qualifying amount. If neither the general tax nor the qualifying levy permits recovery of one or more costs or expenses, and by reason of the failure to permit such recovery the qualifying levy does not satisfy the net income requirement of § 1.901–2(b)(4) (even though the general tax does satisfy that requirement), then such cost or expense shall be considered a cost or expense for purposes of computing the qualifying amount. If the qualifying levy does not permit recovery of one or more significant costs or expenses, but provides allowances that effectively compensate for nonrecovery of such significant costs or expenses, then, for purposes of computing the qualifying amount, costs and expenses shall not include the costs and expenses under the general tax whose nonrecovery under the qualifying levy is compensated for by such allowances but shall instead include such allowances. In determining costs and expenses for purposes of computing the qualifying amount with respect to a qualifying levy, the actual payment amount with respect to such levy shall not be considered a cost or expense. For purposes of this paragraph, the following differences in gross receipts and costs and expenses between the qualifying levy and the general tax shall not be considered to increase the liability imposed on dual capacity taxpayers compared to the general tax liability of persons other than dual capacity taxpayers, but only if the general tax would be an income tax within the meaning of § 1.901–2(a)(1) if such different treatment under the qualifying levy had also applied under the general tax:

(i) Differences in the time of realization or recognition of one or more items of income or in the time when recovery of one or more costs and expenses is allowed (unless the period of recovery of such costs and expenses pursuant to the qualifying levy is such that it effectively is a denial of recovery of such costs and expenses, as described in § 1.901–2(b)(4)(i)); and

(ii) Differences in consolidation or carryover provisions of the types described in paragraphs (b)(4)(ii) and (b)(4)(iii) of § 1.901–2.

(3) *Determination of tax rate.* The tax rate for purposes of the safe harbor formula is the tax rate (expressed as a decimal) that is applicable in computing tax liability under the general tax. If the rate of the general tax varies according to the amount of the base of that tax, the rate to be applied in computing the qualifying amount is the rate that applies under the general tax to a person whose base is, using the terminology of paragraph (e)(1) of this section, ''A'' minus ''B'' minus the specific economic benefit amount paid by the dual capacity taxpayer pursuant to the qualifying levy, provided such rate applies in practice to persons other than dual capacity taxpayers, or, if such rate does not so apply in practice, the next lowest rate of the general tax that does so apply in practice.

(4) *Determination of applicable provisions of general tax*—(i) *In general.* If the general tax is a series of income taxes (*e.g.*, on different types of income), or if the application of the general tax differs by its terms for different classes of persons subject to the general tax (*e.g.*, for persons in different industries), then, except as otherwise provided in this paragraph (e), the qualifying amount small be computed by reference to the income tax contained in such series of income taxes, or in the case of such different applications the application of the general tax, that by its terms and in practice imposes the highest tax burden on persons other than dual capacity taxpayers. Notwithstanding the preceding sentence, the general tax amount shall be computed by reference to the application of the general tax to entities of the same type (as determined under the general tax) as the dual capacity taxpayer and to

persons of the same resident or nonresident status (as determined under the general tax) as the dual capacity taxpayer; and, if the general tax treats business income differently from nonbusiness (*e.g.*, investment) income (as determined under the general tax), the dual capacity taxpayer's business and non-business income shall be treated as the general tax treats such income. If, for example, the dual capacity taxpayer would, under the general tax, be treated as a resident (*e.g.*, because the general tax treats an entity that is organized in the foreign country or managed or controlled there as a resident) and as a corporation (*i.e.*, because the rules of the general tax treat an entity like the dual capacity taxpayer as a corporation), and if some of the dual capacity taxpayer's income would, under the general tax, be treated as business income and some as non-business income, the dual capacity taxpayer and its income shall be so treated in computing the qualifying amount.

(ii) *Establishing that provisions apply in practice.* For purposes of the safe harbor formula a provision (including tax rate) shall be considered a provision of the general tax only if it is reasonably likely that that provision applies by its terms and in practice to persons other than dual capacity taxpayers. In general, it will be assumed that a provision (including tax rate) that by its terms applies to persons other than dual capacity taxpayers is reasonably likely to apply in practice to such other persons, unless the person claiming credit knows or has reason to know otherwise. However, in cases of doubt, the person claiming credit may be required to demonstrate that such provision is reasonably likely so to apply in practice.

(5) *No general tax.* If a foreign country does not impose a general tax (and thus a levy, in order to be a qualifying levy must satisfy all of the criteria of section 901 (because section 903 cannot apply), other than the determination of the distinct element of the levy that is a tax and of the amount that is paid pursuant to that distinct element), paragraphs (e)(2), (3) and (4) of this section do not apply to a qualifying levy of such country, and the terms of the safe harbor formula set forth in paragraph (e)(1) of this section are defined with respect to such levy as follows:

A = the amount of gross receipts as determined under the qualifying levy;

B = the amount of deductions for costs and expenses as determined under the qualifying levy;

C = the actual payment amount; and

D = the lower of the rate of the qualifying levy, or the rate of tax specified in section 11(b)(5) (or predecessor or successor section, as the case may be) of the Internal Revenue Code as applicable to the taxable year in which the actual payment amount is paid.

(6) *Certain taxes in lieu of an income tax.* To the extent a tax in lieu of an income tax (within the meaning of §1.903–1(a)) that applies in practice to persons other than dual capacity taxpayers would actually have been required to be paid in the taxable year by a dual capacity taxpayer if it had not been a dual capacity taxpayer (*e.g.*, in substitution for the general tax with respect to a type of income, such as interest income, dividend income, royalty income, insurance income), such tax in lieu of an income tax shall be treated as if it were an application of the general tax for purposes of applying the safe harbor formula of this paragraph (e) to such dual capacity taxpayer, and such formula shall be applied to yield a qualifying amount that is approximately equal to the general tax (so defined) that would have been required to be paid in the taxable year by such dual capacity taxpayer if the base of such general tax had allowed a deduction in such year for the specific economic benefit amount.

(7) *Multiple levies.* If, in any election year of an electing person, with respect to any elected country and all of its political subdivisions,

(i) Amounts are paid by a dual capacity taxpayer pursuant to more than one qualifying levy or pursuant to one or more levies that are qualifying levies and one or more levies that are not qualifying levies by reason of the last sentence of paragraph (c)(1) of this section but with respect to which credit is allowable, or

(ii) More than one general tax (including a tax treated as if it were an application of the general tax under

paragraph (e)(6)) would have been required to be paid by a dual capacity taxpayer (or taxpayers) if it (or they) had not been a dual capacity taxpayer (or taxpayers), or

(iii) Credit is claimed with respect to amounts paid by more than one dual capacity taxpayer,the provisions of this paragraph (e) shall be applied such that the aggregate qualifying amount with respect to such qualifying levy or levies plus the aggregate amount paid with respect to levies referred to in (e)(7)(i) that are not qualifying levies shall be the aggregate amount that would have been required to be paid in the taxable year by such dual capacity taxpayer (or taxpayers) pursuant to such general tax or taxes if it (or they) had not been a dual capacity taxpayer (or taxpayers) and if the base of such general tax or taxes had allowed a deduction in such year for the aggregate specific economic benefit amount (except that, if paragraph (e)(5) applies to any levy of such elected country or any political subdivision thereof, the aggregate qualifying amount for qualifying levies of such elected country and all of its political subdivisions plus the aggregate amount paid with respect to levies referred to in paragraph (e)(7)(i) that are not qualifying levies shall not exceed the greater of the aggregate amount paid with respect to levies referred to in paragraph (e)(7)(i) that are not qualifying levies and the amount determined in accordance with paragraph (e)(5) where ''D'' is the rate of tax specified in section 11(b)(5) (or predecessor or successor section, as the case may be) of the Internal Revenue Code as applicable to the taxable year in which the actual payment amount is paid). However, in no event shall such aggregate amount exceed the aggregate actual payment amount plus the aggregate amount paid with respect to levies referred to in (e)(7)(i) that are not qualifying levies, nor be less than the aggregate amount paid with respect to levies referred to in (e)(7)(i) that are not qualifying levies. In applying (e)(7)(ii) a person who is not subject to a levy but who is considered to receive a specific economic benefit by reason of §1.901–2(a)(2)(ii)(E) shall be treated as a dual capacity taxpayer. See example 12 in paragraph (e)(8) of this section.

(8) *Examples.* The provisions of this paragraph (e) may be illustrated by the following examples:

Example 1. Under a levy of country X called the country X income tax, every corporation that does business in country X is required to pay to country X 40% of its income from its business in country X. Income for purposes of the country X income tax is computed by subtracting specified deductions from the corporation's gross income derived from its business in country X. The specified deductions include the corporation's expenses attributable to such gross income and allowances for recovery of the cost of capital expenditures attributable to such gross income, except that under the terms of the country X income tax a corporation engaged in the exploitation of minerals K, L or M in country X is not permitted to recover, currently or in the future, expenditures it incurs in exploring for those minerals. Under the terms of the country X income tax interest is not deductible to the extent it exceeds an arm's length amount (*e.g.,* if the loan to which the interest relates is not in accordance with normal commercial practice or to the extent the interest rate exceeds an arm's length rate). In practice, the only corporations that engage in exploitation of the specified minerals in country X are dual capacity taxpayers. Because no other persons subject to the levy engage in exploitation of minerals K, L or M in country X, the application of the country X income tax to dual capacity taxpayers is different from its application to other corporations. The country X income tax as applied to corporations that engage in the exploitation of minerals K, L or M (dual capacity taxpayers) is, therefore, a separate levy from the country X income tax as applied to other corporations.

A is a U.S. corporation that is engaged in country X in exploitation of mineral K. Natural deposits of mineral K in country X are owned by country X, and *A* has been allowed to extract mineral K in consideration of payment of a bonus and of royalties to an instrumentality of country X. Therefore, *A* is a dual capacity taxpayer. In 1984, *A* does business in country X within the meaning of the levy. *A* has validly elected the safe harbor method for country X for 1984. In 1984, as determined in accordance with the country X income tax as applied to *A, A* has gross receipts of 120u (units of country X currency), deducts 20u of costs and expenses, and pays 40u (40% of (120u–20u)) to country X pursuant to the levy. *A* also incurs in 1984 10u of nondeductible expenditures for exploration for mineral K and 2u of nondeductible interest costs attributable to an advance of funds

from a related party to finance an undertaking relating to the exploration for mineral K for which normal commercial financing was unavailable because of the substantial risk inherent in the undertaking. *A* establishes that the country X income tax as applied to persons other than dual capacity taxpayers is an income tax within the meaning of §1.901–2(a)(1), that it is the generally imposed income tax of country X and hence the general tax, and that all of the criteria of section 903 are satisfied with respect to the country X income tax as applied to dual capacity taxpayers, except for the determination of the distinct element of the levy that is a tax and of *A*'s qualifying amount with respect thereto. (No conclusion is reached whether the country X income tax as applied to dual capacity taxpayers is an income tax within the meaning of §1.901–2(a)(1). Such a determination would require, among other things, that the country X income tax as so applied, judged on the basis of its predominant character, meets the net income requirement of §1.901–2(b)(4) notwithstanding its failure to permit recovery of exploration expenses.) *A* has therefore demonstrated that the country X income tax as applied to dual capacity taxpayers is a qualifying levy.

In applying the safe harbor formula, in accordance with paragraph (e)(2), the amount of *A*'s costs and expenses includes the 10u of nondeductible exploration expenses. The failure to permit recovery of interest in excess of arm's length amounts, a provision of both the general tax and the qualifying levy, does not cause the qualifying levy to fail to satisfy the net income requirement of §1.901–2(b)(4); therefore, the amount of *A*'s costs and expenses does not include the 2u of nondeductible interest costs. Thus, under the safe harbor method, *A*'s qualifying amount with respect to the levy is 33.33u ((120u − 30u − 40u) × .40/(1 − .40)). *A*'s specific economic benefit amount is 6.67u (*A*'s actual payment amount (40u) less *A*'s qualifying amount (33.33u)). Under paragraph (a) of this section, this 6.67u is considered to be consideration paid by *A* for the right to extract mineral K. Pursuant to paragraph (b) of this section, this amount is characterized according to the nature of *A*'s transactions with country X and its instrumentality and of the specific economic benefit received (the right to extract mineral K), as an additional royalty or other business expense paid or accrued by *A* and is so treated for all purposes of chapter 1 of the Internal Revenue Code, except that if an allowance for percentage depletion is allowable to *A* under sections 611 and 613 with respect to *A*'s interest in mineral K, the determination whether this 6.67u is tax or royalty for purposes of computing the amount of such allowance shall be made under sections 611 and 613 without regard to the determination that under the safe harbor formula such 6.67u is not tax for purposes of section 901 or 903.

Example 2. Under a levy of country Y called the country Y income tax, each corporation incorporated in country Y is required to pay to country Y a percentage of its worldwide income. The applicable percentage is 40 percent of the first 1,000u (units of country Y currency) of income and 50 percent of income in excess of 1,000u. Income for purposes of the levy is computed by deducting from gross income specified types of expenses and specified allowances for capital expenditures. The expenses for which deductions are permitted differ depending on the type of business in which the corporation subject to the levy is engaged, *e.g.*, a deduction for interest paid to a related party is not allowed for corporations engaged in enumerated types of activities. In addition, carryover of losses from one taxable period to another is permitted for corporations engaged in specified types of activities, but not for corporations engaged in other activities. By its terms, the foreign levy makes no distinction between dual capacity taxpayers and other persons. In practice the differences in the base of the country Y income tax (*e.g.*, the lack of a deduction for interest paid to related parties for some corporations subject to the levy and the lack of a carryover provision for some corporations subject to the levy) apply to both dual capacity taxpayers and other persons, but the 50 percent rate applies only to dual capacity taxpayers. By reason of such higher rate, application of the country Y income tax to dual capacity taxpayers is different in practice from application of the country Y income tax to other persons subject to it. The country Y income tax as applied to dual capacity taxpayers is therefore a separate levy from the country Y income tax as applied to other corporations incorporated in country Y.

B is a corporation incorporated in country Y that is engaged in construction activities in country Y. *B* has a contract with the government of country Y to build a hospital in country Y for a fee that is not made available on substantially the same terms to substantially all persons who are subject to the general tax of country X. Accordingly, *B* is a dual capacity taxpayer. *B* has validly elected the safe harbor method for country Y for 1985. In 1985, as determined in accordance with the country Y income tax as applied to *B*, *B* has gross receipts of 10,000u, deducts 6,000u of costs and expenses, and pays 1900u ((1,000u × 40%) + (3,000u × 50%)) to country Y pursuant to the levy.

It is assumed that *B* has established that the country Y income tax as applied to persons other than dual capacity taxpayers is an income tax within the meaning of §1.901–2(a)(1) and is the general tax. It is further assumed that *B* has demonstrated that all of the criteria of section 901 are satisfied with

respect to the country Y income tax as applied to dual capacity taxpayers, except for the determination of the distinct element of such levy that is a tax and of *B*'s qualifying amount with respect to that levy, and therefore that the country Y income tax as applied to dual capacity taxpayers is a qualifying levy.

In applying the safe harbor formula, in accordance with paragraph (e)(3), the 50 percent rate is not used because it does not apply in practice to persons other than dual capacity taxpayers. The next lowest rate of the general tax that does apply in practice to such persons, 40 percent, is used. Accordingly, under the safe harbor formula, *B*'s qualifying amount with respect to the levy is 1400u ((10,000u − 6000u − 1900u) × .40/(1 − .40)). *B*'s specific economic benefit amount is 500u (B's actual payment amount (1900u) less *B*'s qualifying amount (1400u)). Pursuant to paragraph (b) of this section, *B*'s specific economic benefit amount is characterized according to the nature of *B*'s transactions with country Y and of the specific economic benefit received, as a reduction of *B*'s proceeds of its contract with country Y; and this amount is so treated for all purposes of chapter 1 of the Code, including the computation of *B*'s accumulated profits for purposes of section 902.

Example 3. The facts are the same as in example 2, with the following additional facts: The contract between *B* and country Y is a cost plus contract. One of the costs of the contract which country Y is required to pay or for which it is required to reimburse *B* is any tax of country Y on *B*'s income or receipts from the contract. Instead of reimbursing *B* therefor, country Y agrees with *B* to assume any such tax liability. Under country Y tax law, *B* is not considered to have additional income or receipts by reason of country Y's assumption of *B*'s country Y tax liability. In 1985, *B*'s gross receipts of 10,000u include 3000u from the contract, and its costs and expenses of 6000u include 2000u attributable to the contract. *B*'s other gross receipts and expenses do not relate to any transaction in which B receives a specific economic benefit. In accordance with the contract, country Y, and not *B*, is required to bear the amount of *B*'s country Y income tax liability on *B*'s 1000u (3000u–2000u) income from the contract. In accordance with the contract *B* computes its country Y income tax without taking this 1000u into account and therefore pays 1400u ((1000u × 40%) + (2000u × 50%)) to country Y pursuant to the levy.

In accordance with §1.901–2(f)(2)(i), the country Y income tax which country Y is, under the contract, required to bear is considered to be paid by country Y on behalf of *B*. *B*'s proceeds of its contract, for all purposes of chapter 1 of the Code (including the computation of *B*'s accumulated profits for purposes of section 902), therefore, are increased by the additional 500u (1900u computed as in example 2 less 1400u as computed above) of *B's* liability under the country Y income tax that is assumed by country Y and such 500u is considered to be paid pursuant to the levy by country Y on behalf of *B*. In applying the safe harbor formula, therefore, the computation is exactly as in example 2 and the results are the same as in example 2.

Example 4. Country L issues a decree (the ''April 11 decree''), in which it states it is exercising its tax authority to impose a tax on all corporations on their ''net income'' from country L. ''Net income'' is defined as actual gross receipts less all expenses attributable thereto, except that in the case of income from extraction of petroleum, gross receipts are defined as 105 percent of actual gross receipts, and no deduction is allowed for interest incurred on loans whose proceeds are used for exploration for petroleum. Under the April 11 decree, wages paid by corporations subject to the decree are deductible in the year of payment, except that corporations engaged in the extraction of petroleum may deduct such wages only by amortization over a 5-year period and, to the extent such wages are paid to officers, they may be deducted only by amortization over a period of 50 years. The April 11 decree permits related corporations subject to the decree to file consolidated returns in which net income and net losses of related corporations offset each other in computing net income for purposes of the April 11 decree, except that corporations engaged in petroleum exploration or extraction activities are not eligible for inclusion in such a consolidated return. The law of country L does not require separate entities to carry on separate activities in connection with exploring for or extracting petroleum. Net losses of a taxable year may be carried over for 10 years to offset income, except that no more than 25% of net income (before deducting the loss carryover) in any such future year may be offset by a carryover of net loss, and, in the case of any corporation engaged in exploration or extraction of petroleum, losses incurred prior to such a corporation's having net income from production may be carried forward for only 8 years and no more than 15% of net income in any such future year may be offset by such a net loss. The rate to be paid under the April 11 decree is 50% of net income (as defined in the levy), except that if net income exceeds 10,000u (units of country L currency), the rate is 75% of the corporation's net income (including the first 10,000u thereof). In practice, no corporations other than corporations engaged in extraction of petroleum have net income in excess of 10,000u. All petroleum resources of country L are owned by

the government of country L, whose petroleum ministry licenses corporations to explore for and extract petroleum in consideration for payment of royalties as petroleum is produced.

J is a U.S. corporation that is engaged in country L in the exploration and extraction of petroleum and therefore is a dual capacity taxpayer. *J* has validly elected the safe harbor method for country L for the year 1983, the year that *J* commenced activities in country L, and has not revoked such election. For the years 1983 through 1986, *J*'s gross receipts, deductions and net income before application of the carryover provisions, determined in accordance with the April 11 decree, are as follows:

Year	Gross receipts (105 percent of actual gross receipts)	Deductions other than wages	Wages paid other than to officers (amortizable at 20 percent)	Wages paid to officers (amortizable at 2 percent)	Nondeductible exploration interest expense	Net income (loss) (B-C-amortization of cumulative D-amortization of cumulative E)
A.	B.	C.	D.	E.	F.	G.
1983	0	13,000u	100u	50u	1,000u	(13,021u)
1984	0	17,000u	100u	50u	2,800u	(17,042u)
1985	42,000u	15,000u	100u	50u	2,800u	26,937u
1986	105,000u	20,000u	100u	50u	2,800u	84,916u

After application of the carryover provisions, *J*'s net income and actual payment amounts pursuant to the April 11 levy are as follows:

Year	Net income (loss)	Actual payment amount (*I* × 75 percent)
H.	*I.*	*J.*
1983	(13,021u)	0
1984	(17,042u)	0
1985	22,896u	17,172u
1986	72,179u	54,134u

Pursuant to paragraph (a)(1) of this section, the April 11 decree as applied to corporations engaged in the exploration or extraction of petroleum in country L is a separate levy from the April 11 decree as applied to all other corporations. *J* establishes that the April 11 decree, as applied to such other corporations, is an income tax within the meaning of §1.901–2(a)(1) and that the decree as so applied is the general tax.

The April 11 decree as applied to corporations engaged in the exploration or extraction of petroleum in country L does not meet the gross receipts requirement of §1.901–2(b)(3); therefore, irrespective of whether it meets the other requirements of §1.901–2(b)(1), it is not an income tax within the meaning of §1.901–2(a)(1). However, the April 11 decree as applied to such corporations is a qualifying levy because *J* has demonstrated that all of the criteria of section 903 are satisfied with respect to the April 11 decree as applied to such corporations, except for the determination of the distinct element of such levy that imposes a tax and of *J*'s qualifying amount with respect thereto.

In applying the safe harbor formula, in accordance with paragraph (e)(2), gross receipts are computed by reference to the general levy, and thus are 100%, not 105%, of actual gross receipts. Similarly, costs and expenses include exploration interest expense. In accordance with paragraph (e)(2)(i) of this section the difference between the general tax and the qualifying levy in the timing of the deduction for wages, other than wages of officers, is not considered to increase the liability of dual capacity taxpayers because the general tax would not have failed to be an income tax within the meaning of §1.901–2(a)(1) if it had provided for 5-year amortization of such wages instead of for current deduction. *See* §1.901–2(b)(4)(i). However, amortization of wages paid to officers over a 50-year period is such a deferred recovery of such wages that it effectively is a denial of the deduction of the excess of such wages paid in any year over the amortization of such cumulative wages permitted in such year. See §1.901–2(b)(4)(i). The different treatment of wages paid to officers under the general tax and the qualifying levy is thus not merely a difference in timing within the meaning of paragraph (e)(2)(i) of this section. Accordingly, the difference between the amount of wages paid by *J* to officers in any year and *J*'s deduction (in computing the actual payment amount) for amortization of such cumulative wages allowed in such year is, pursuant to paragraph (e)(2) of this section, treated as a cost and expense in computing *J*'s qualifying amount for such year with respect to the April 11 decree. The differences in the consolidation and carryover provisions between the general tax and the qualifying levy are of the types described in paragraph (e)(2)(ii) of this section and, pursuant to paragraphs (b)(4)(ii) and (b)(4)(iii) of

§ 1.901–2, the general tax would not fail to be an income tax within the meaning of § 1.901–2(a)(i) even if it contained the consolidation and carryover provisions of the qualifying levy. Thus, such differences are not considered to increase the liability of dual capacity taxpayers pursuant to the qualifying levy as compared to the general tax liability of persons other than dual capacity taxpayers.

Accordingly, in applying the safe harbor formula to the qualifying levy for 1985 and 1986, gross receipts and costs and expenses are computed as follows:

Gross receipts

1985: 42,000u × (100/105) − 40,000u
1986: 105,000u × (100/105) − 100,000u

COSTS AND EXPENSES

Item	1985	1986
1. Deductions other than wages (column C in the preceding chart)	15,000u	20,000u
2. Amortization of cumulative wages paid in 1983 and thereafter other than to officers	60u	80u
3. Deduction of wages to officers paid in current year, instead of amortization allowed in current year of such cumulative wages paid in 1983 and thereafter	50u	50u
4. Deduction of exploration interest expense	2,800u	2,800u
5. Costs and expenses before carryover of net loss (sum of lines 1 through 4)	17,910u	22,930u
6. Recalculation of loss carryover by recalculating 1983 and 1984 net income (loss) to reflect current deduction of wages to officers and exploration interest expense: 1983 adjusted net loss carryover: (13,021u) + (49u) + (1000u) = (14,070u); 1984 adjusted net loss carryover: (17,042u) + (48u) + (2800u) = (19,890u).		
7. Recalculation of limitation on use of net loss carryover deduction:		
Gross receipts	40,000u	100,000u
Less costs and expenses	(17,910u)	(22,930)
Total	22,090u	77,070u
Times 15 percent limitation	3,314u	11,561u
8. Costs and expenses including net loss carryover deduction (line 5 plus line 7)	21,224u	34,491u

In years after 1986, costs and expenses for purposes of determining the qualifying amount would reflect net loss carryforward deductions based on the recomputed losses carried forward from 1983 and 1984 (14,070u and 19,890u, respectively) less the amounts thereof that were utilized in determining costs and expenses for 1985 and 1986 (3,314u and 11,561u, respectively). The 1983 and 1984 loss carryforwards would be considered utilized in accordance with the order of priority in which such losses are utilized under the terms of the qualifying levy.

In applying the safe harbor formula, the tax rate to be used, in accordance with paragraph (e)(3) of this section, is .50.

Accordingly, under the safe harbor method, *J*'s qualifying amounts with respect to the April 11 decree for 1985 and 1986 are computed as follows:

1985: (40,000u − 21,224u − 17,172u) × .50 / (1 − .50) = 1604u

1986: (100,000u − 34,491u − 54,134u) × .50 / (1 − .50) = 11,375u

Under the safe harbor method *J*'s qualifying amounts with respect to the April 11 decree for 1985 and 1986 are thus 1604u and 11,375u, respectively; and its specific economic benefit amounts are 15,568u (17,172u–1604u) and 42,759u, (54,134u–11,375u), respectively. Pursuant to paragraph (b) of this section, *J*'s specific economic benefit amounts are characterized according to the nature of *J*'s transactions with country L and of the specific economic benefit received by *J* as additional royalties paid to country L with respect to the petroleum extracted by *J* in country L in 1985 and 1986, and these amounts are so treated for all purposes of chapter 1 of the Code.

Example 5. Country E, which has no generally imposed income tax, imposes a levy called the country E income tax only on corporations carrying on the banking business through a branch in country E and on corporations engaged in the extraction of petroleum in country E. All of the petroleum resources of country E are owned by the government of country E, whose petroleum ministry licenses corporations to explore for and extract petroleum in consideration of payment of royalties as petroleum is extracted. The base of the country E income tax is a corporation's actual gross receipts from sources in country E less all expenses attributable, on reasonable principles, to such gross receipts; the rate of tax is 29 percent.

A is a U.S corporation that carries on the banking business through a branch in country E. *B* is a U.S. corporation (unrelated to *A*) that is engaged in the extraction of petroleum in country E. In 1984 *A* receives interest on loans it has made to 160 borrowers in country E, seven of which are agencies and instrumentalities of the government of country E. The economic benefits received by *A* and *B* (*i.e.*, the interest received by *A* from the government and B's license to extract petroleum owned by the government) are not made available on substantially the same terms to the population of country E in general.

A and *B* are dual capacity taxpayers. Each of them has validly elected the safe harbor method for country E for 1984. *A* demonstrates that the country E income tax as applied to it (a dual capacity taxpayer) is not different by its terms or in practice from the country E income tax as applied to persons (in this case other banks) that are not dual capacity taxpayers. *A* has therefore established pursuant to paragraph (a)(1) of this section and §1.901–2(d) that the country E income tax as applied to it and the country E income tax as applied to persons other than dual capacity taxpayers are together a single levy. *A* establishes that such levy is an income tax within the meaning of §1.901–2(a)(1). In accordance with paragraph (a)(1) of this section, no portion of the amount paid by *A* pursuant to such levy is considered to be paid in exchange for a specific economic benefit. Thus, the entire amount paid by *A* pursuant to this levy is an amount of income tax paid.

B does not demonstrate that the country E income tax as applied to corporations engaged in the extraction of petroleum in country E (dual capacity taxpayers) is not different by its terms or in practice from the country E income tax as applied to persons other than dual capacity taxpayers (*i.e.*, banks that are not dual capacity taxpayers). Accordingly, pursuant to paragraph (a)(1) of this section and §1.901–2(d), the country E income tax as applied to corporations engaged in the extraction of petroleum in country E is a separate levy from the country E income tax as applied to other persons.

B demonstrates that all of the criteria of section 901 are satisfied with respect to the country E income tax as applied to corporations engaged in the exploration of petroleum in country E, except for the determination of the distinct element of such levy that imposes a tax and of *B*'s qualifying amount with respect to the levy. Pursuant to paragraph (e)(5) of this section, in applying the safe harbor formula to *B*, ''A'' is the amount of *B*'s gross receipts as determined under the country E income tax as applied to *B*; ''B'' is the amount of *B*'s costs and expenses as determined thereunder; ''C'' is *B*'s actual payment amount; and ''D'' is .29, the lower of the rate (29 percent) of the qualifying levy (the country E income tax as applied to corporations engaged in the extraction of petroleum in country E) or the rate (46 percent) of tax specified for 1984 in section 11(b)(5) of the Internal Revenue Code. Thus, *B*'s qualifying amount is equal to its actual payment amount.

Example 6. The facts are the same as in example 5, except that the rate of the country E income tax is 55 percent. For the reasons stated in example 5, the results with respect to *A* are the same as in example 5. In applying the safe harbor formula to *B*, ''A,'' ''B,'' and ''C'' are the same as in example 5, but ''D'' is .46, as that rate is less than .55. Thus, *B*'s qualifying amount is less than *B*'s actual payment amount, and the difference is *B*'s specific economic benefit amount.

Example 7. Country E imposes a tax (called the country E income tax) on the realized net income derived by corporations from sources in country E, except that, with respect to interest income received from sources in country E and certain insurance income, nonresident corporations are instead subject to other levies. With respect to such interest income a levy (called the country E interest tax) requires nonresident corporations to pay to country E 20 percent of such gross interest income unless the nonresident corporation falls within a specified category of corporations (''special corporations''), all of which are dual capacity taxpayers, in which case the rate is instead 25 percent. With respect to such insurance income nonresident corporations are subject to a levy (called the country E insurance tax), which is not an income tax within the meaning of §1.901–2(a)(1).

The country E interest tax applies at the 20 percent rate by its terms and in practice to persons other than dual capacity taxpayers. The country E interest tax as applied at the 25 percent rate to special corporations applies only to dual capacity taxpayers; therefore, the country E interest tax as applied to special corporations is a separate levy from the country E interest tax as applied at the 20 percent rate.

A is a U.S. corporation which is a special corporation subject to the 25 percent rate of the country E interest tax. *A* does not have any insurance income that is subject to the country E insurance tax. *A*, a dual capacity taxpayer, has validly elected the safe harbor formula for 1984. In 1984 *A* receives 100u (units of country E currency) of gross interest income subject to the country E interest tax and pays 25u to country E.

A establishes that the country E income tax is the generally imposed income tax of country E; that all of the criteria of section 903 are satisfied with respect to the country E interest tax as applied to special corporations except for the determination of the distinct element of the levy that is a tax and of *A*'s qualifying amount with respect thereto. *A* has therefore demonstrated that the country E interest tax as applied to special corporations is a qualifying levy. *A* establishes that the country E interest tax at the 20 percent rate is a tax in lieu of an income tax within the meaning of §1.903–1(a). Pursuant to paragraph (e)(6) of this section the country E interest tax at the 20 percent rate is treated as if it were an application of the general tax for purposes of the safe harbor formula of this paragraph (e), since that tax would actually have been required to have been paid by *A* with respect to its interest

income had *A* not been a dual capacity taxpayer (special corporation) instead subject to the qualifying levy (the country E interest tax at the 25 percent rate).

Even if the country E insurance tax is a tax in lieu of an income tax within the meaning of §1.903–1(a), that tax is not treated as if it were an application of the general tax for purposes of applying the safe harbor formula to *A* since *A* had no insurance income in 1984 and hence such tax would not actually have been required to be paid by *A* had *A* not been a dual capacity taxpayer.

Example 8. Under a levy of country S called the country S income tax, each corporation operating in country S is required to pay country S 50 percent of its income from operations in country S. Income for purposes of the country S income tax is computed by subtracting all attributable costs and expenses from a corporation's gross receipts derived from its business in country S. Among corporations on which the country S income tax is imposed are corporations engaged in the exploitation of mineral K in country S. Natural deposits of mineral K in country S are owned by country S, and all corporations engaged in the exploitation thereof do so under concession agreement with an instrumentality of country S. Such corporations, in addition to the 50 percent country S income tax, are also subject to a levy called a surtax, which is equal to 60 percent of posted price net income less the amount of the contry S income tax. The surtax is not deductible in computing the country S income tax of corporations engaged in the exploitation of mineral K in country S.

A is a U.S. corporation engaged in country S in the exploitation of mineral K, and *A* has been allowed to extract mineral K under a concession agreement with an instrumentality of country S. Therefore, *A* is a dual capacity taxpayer. In accordance with a term of the concession agreement, certain of *A*'s income (net of expenses attributable thereto) is exempted from the income tax and surtax.

The results for *A* in 1984 are as follows:

	Income Tax	Surtax
Gross Receipts:		
Realized—Taxable	120u	—
Realized—Exempt	15u	—
Posted Price-Taxable	—	145u
Costs:		
Attributable to Taxable Receipts	20u	20u
Attributable to Exempt Receipts	5u	—
Taxable Income	100u	125u
Tentative Surtax (60 percent)	—	75u
Petroleum Levy at 50 percent	50u	50u
Surtax	—	25u

Because of the difference (nondeductibility of the surtax) in the country S income tax as applied to dual capacity taxpayers from its application to other persons, the country S income tax as applied to dual capacity taxpayers and the country S income tax as applied to persons other than dual capacity taxpayers are separate levies. Moreover, because *A*'s concession agreement provides for a modification (exemption of certain income) of the country S income tax and surtax as they otherwise apply to other persons engaged in the exploitation of mineral K in country S, those levies (contractual levies) as applied to *A* are separate levies from those levies as applied to other persons engaged in the exploitation of mineral K in country S.

A establishes that the country S income tax as applied to persons other than dual capacity taxpayers is an income tax within the meaning of §1.901–2(a)(1) and is the general tax. *A* demonstrates that all the criteria of section 903 are satisfied with respect to the country S income tax as applied to *A* and with respect to the surtax as applied to *A*, except for the determination of the distinct elements of such levies that are taxes and of *A*'s qualifying amounts with respect to such levies. Therefore, both the country S income tax as applied to *A* and the surtax as applied to *A* are qualifying levies.

In applying the safe harbor formula, in accordance with paragraph (e)(2), the amount of *A*'s gross receipts includes the exempt realized income, and the amount of *A*'s costs and expenses includes the costs attributable to such exempt income. In accordance with paragraph (e)(7)(i), the amount of the qualifying levy for purposes of the formula is the sum of *A*'s liability for the country S income tax and *A*'s liability for the surtax. Accordingly, under the safe harbor formula, *A*'s qualifying amount with respect to the country S income tax and the surtax is 35u $((135u - 25u - 75u) \times .50/(1 - .50))$. *A*'s specific economic benefit amount is 40u (*A*'s actual payment amount (75u) less *A*'s qualifying amount (35u)).

Example 9. Country T imposes a levy on corporations, called the country T income tax. The country T income tax is imposed at a rate of 50 percent on gross receipts less all costs and expenses, and affiliated corporations are allowed to consolidate their results in applying the country T income tax. Corporations engaged in the exploitation of mineral L in country T are subject to a levy that is identical to the country T income tax except that no consolidation among affiliated corporations is allowed. The levy allows unlimited loss carryforwards.

C and *D* are affiliated U.S. corporations engaged in country T in the exploitation of mineral L. Natural deposits of mineral L in country T are owned by country T, and *C* and *D* have been allowed to extract mineral L in consideration of certain payments to an instrumentality of country T. Therefore, *C* and *D* are dual capacity taxpayers.

The results for *C* and *D* in 1984 and 1985 are as follows:

	1984		1985	
	C	*D*	*C*	*D*
Gross Receipts	120u	0	120u	120u
Costs	20u	50u	20u	20u
Loss Carryforward	.....	.....	.....	50u
Net Income (Loss)	100u	(50u)	100u	50u
Income Tax	50u	.....	50u	25u

C and *D* establish that the country T income tax as applied to persons other than dual capacity taxpayers is an income tax within the meaning of §1.901–2(a)(1) and is the general tax. *C* and *D* demonstrate that all of the criteria of section 901 are satisfied with respect to the country T income tax as applied to dual capacity taxpayers, except for the determination of the distinct element of such levy that is a tax and of *C* and *D*'s qualifying amounts with respect to that levy. Therefore, the country T income tax as applied to dual capacity taxpayers is a qualifying levy.

In applying the safe harbor formula, in accordance with paragraphs (e)(2)(ii) and (e)(7)(iii), the gross receipts, costs and expenses, and actual payment amounts of *C* and *D* are aggregated, except that in *D*'s loss year (1984) its gross receipts and costs and expenses are disregarded. The results of any loss year are disregarded since the country T income tax as applied to dual capacity taxpayers does not allow consolidation, and, pursuant to paragraph (e)(2)(ii), differences in consolidation provisions between such levy and the country T income tax as applied to persons that are not dual capacity taxpayers are not considered. Accordingly, in 1984 the qualifying amount with respect to the country T income tax is 50u ((120u − 20u − 50u) × .50/(1 − .50)), all of which is considered paid by *C*. In 1985 the qualifying amount is 75u ((120u + 120u − 20u − 20u − 50u (loss carry forward)—50u—25u) × .50/(1 − .50)), of which 50u is considered to be paid by *C* and 25u by *D*.

Example 10. Country W imposes a levy called the country W income tax on corporations doing business in country W. The country W income tax is imposed at a 50 percent rate on gross receipts less all costs and expenses. Corporations engaged in the exploitation of mineral M in country W are subject to a levy that is identical in all respects to the country W income tax except that it is imposed at a rate of 80 percent (the ''80 percent levy'').

A is a U.S. corporation engaged in country W in exploitation of mineral M and is subject to the 80 percent levy. Natural deposits of mineral M in country W are owned by country W, and *A* has been allowed to extract mineral M in consideration of certain payments to an instrumentality of country W. Therefore, *A* is a dual capacity taxpayer. *B*, a U.S. corporation affiliated with *A*, also is engaged in business in country W, but has no transactions with country W. *B* is subject to the country W income tax. *B* is a dual capacity taxpayer within the meaning of §1.901–2(a)(2)(ii)(A) by virtue of its affiliation with *A*.

The results for *A* and *B* in 1984 are as follows:

	A	*B*
Gross Receipts	120u	100u
Costs	20u	40u
Net Income	100u	60u
Tax Rate	.80	.50
Tax	80u	30u

A and *B* establish that the country W income tax as applied to persons other than dual capacity taxpayers is an income tax within the meaning of §1.901–2(a)(1) and is the general tax. It is assumed that *B* has demonstrated that the country W income tax as applied to *B* does not differ by its terms or in practice from the country W income tax as applied to persons other than dual capacity taxpayers and hence that the country W income tax as applied to *B*, a dual capacity taxpayer, and the country W income tax as applied to such other persons is a single levy. Thus, with respect to *B*, the country W income tax is not a qualifying levy by reason of the last sentence of paragraph (c)(1) of this section. *A* demonstrates that all the criteria of section 901 are satisfied with respect to the 80 percent levy, except for the determination of the distinct element of such levy that is a tax and of *A*'s qualifying amount with respect thereto. Accordingly, the 80 percent levy as applied to *A* is a qualifying levy.

In applying the safe harbor formula in accordance with paragraphs (e)(7)(i) and (e)(7)(iii) in the instant case, it is not necessary to incorporate *B*'s results in the safe harbor formula because *B*'s taxation in country W is identical to the taxation of persons other than dual capacity taxpayers and because neither *A*'s and *B*'s results nor their taxation in country W interact in any way to change *A*'s taxation. All of the amount paid by *B*, 30u, is an amount of income tax paid by *B* within the meaning of §1.901–2(a)(1). Accordingly, under the safe harbor formula, the qualifying amount for *A* with respect to the 80 percent levy is 20u ((120u − 20u − 80u) × .50/(1 − .50)). The remaining 60u paid by *A* (80u − 20u) is *A*'s specific economic benefit amount.

Example 11. The facts are the same as in example 10, except that it is assumed that *B* has not demonstrated that the country W income tax as applied to *B* does not differ by its terms or in practice from the country W income tax as applied to persons other than dual capacity taxpayers. In addition, *A* and *B* demonstrate that all the criteria of section 901 are satisfied with respect to each of the country W income tax and the 80 percent levy as applied to dual capacity taxpayers, except for the determination of the distinct

elements of such levies that are taxes of *A* and *B*'s qualifying amounts with respect to such levies. Therefore, the country W income tax and 80 percent levy as applied to dual capacity taxpayers are qualifying levies.

In applying the safe harbor formula in accordance with paragraphs (e)(7)(i) and (e)(7)(iii), the results of *A* and *B* are aggregated. Accordingly, under the safe harbor formula, the aggregate qualifying amount for *A* and *B* with respect to the country W income tax and 80 percent levy is 50u ([(120u + 100u) − (20u + 40u) − (80u + 30u)] × .50/(1 − .50)).

Example 12. Country Y imposes a levy on corporations operating in country Y, called the country Y income tax. Income for purposes of the country Y income tax is computed by subtracting all costs and expenses from a corporation's gross receipts derived from its business in country Y. The rate of the country Y income tax is 50 percent. Country Y also imposes a 20 percent tax (the ''withholding tax'') on the gross amount of certain income, including dividends, received by persons who are not residents of country Y from persons who are residents of country Y and from corporations that operate there. Corporations engaged in the exploitation of mineral K in country Y are subject to a levy (the ''75 percent levy'') that is identical in all respects to the country Y income tax except that it is imposed at a rate of 75 percent. Dividends received from such corporations are not subject to the withholding tax.

C, a wholly-owned country Y subsidiary of *D*, a U.S. corporation, is engaged in country Y in the exploitation of mineral K. Natural deposits of mineral K in country Y are owned by country Y, and *C* has been allowed to extract mineral K in consideration of certain payments to an instrumentality of country Y. Therefore, *C* is a dual capacity taxpayer. *D* has elected the safe harbor method for country Y for 1984. In 1984, *C*'s gross receipts are 120u (units of country Y currency), its costs and expenses are 20u, and its liability under the 75 percent levy is 75u. *C* distributes the amount that remains, 25u, as a dividend to *D*.

D establishes that the country Y income tax as applied to persons other than dual capacity taxpayers is an income tax within the meaning of § 1.901–2(a)(1) and the general tax, and that all the criteria of section 901 are satisfied with respect to the 75 percent levy, except for the determination of the distinct element of such levy that is tax and of *C*'s qualifying amount with respect thereto. Accordingly, the 75 percent levy is a qualifying levy.

Pursuant to paragraph (e)(7), *D* (which is not subject to a levy of country Y but is considered to receive a specific economic benefit by reason of § 1.901–2(a)(2)(ii)(E)) is treated as a dual capacity taxpayer in applying paragraph (e)(7)(ii). *D* demonstrates that the withholding tax is a tax in lieu of an income tax within the meaning of § 1.903–1, which tax applies in practice to persons other than dual capacity taxpayers, and that such tax actually would have applied to *D* had *D* not been a dual capacity taxpayer (*i.e.*, had *C* not been a dual capacity taxpayer, in which case *D* also would not have been one). Accordingly, the withholding tax is treated for purposes of the safe harbor formula as if it were an application of the general tax.

In applying the safe harbor formula to this situation in accordance with paragraph (e)(7)(ii), the rates of the country Y income tax and the withholding tax are aggregated into a single effective general tax rate. In this case, the rate is .60 (.50 + [(1 − .50) × .20]). Accordingly, under the safe harbor formula, *C*'s qualifying amount with respect to the 75 percent levy is 37.5u [(120u − 20u − 75u) × .60/(1 − .60)], the aggregate amount that *C* and *D* would have paid if *C* had been subject to the country Y income tax and had distributed to *D* as a dividend subject to the withholding tax the entire amount that remained for the year after payment of the country Y income tax. Because *C* is in fact the only taxpayer, the entire qualifying amount is paid by *C*.

Example 13. The facts are the same as in example 12, except that dividends received from corporations engaged in the exploitation of mineral K in country Y are subject to the withholding tax. Thus, *C*'s liability under the 75 percent levy is 75u, and *D*'s liability under the withholding tax on the 25u distribution is 5u.

D, which is a dual capacity taxpayer, demonstrates that the withholding tax as applied to *D* does not differ by its terms or in practice from the withholding tax as applied to persons other than dual capacity taxpayers and hence that the withholding tax as applied to *D* and that levy as applied to such other persons is a single levy. *D* demonstrates that all of the criteria of section 903 are satisfied with respect to the withholding tax. The withholding tax is not a qualifying levy by reason of the last sentence of paragraph (c)(1) of this section.

Paragraphs (e)(7)(i), (e)(7)(ii) and (e)(7)(iii) all apply in this situation. As in example 10, it is not necessary to incorporate the withholding tax into the safe harbor formula. All of the amount paid by *D*, 5u, is an amount of tax paid by *D* in lieu of an income tax. In applying the safe harbor formula to *C*, therefore, with respect to the 75 percent levy, ''A'' is 120, ''B'' is ''20'', ''C'' is 75 and ''D'' is .50. Accordingly, *C*'s qualifying amount with respect to the 75 percent levy is 25u; the remaining 50u that it paid is its specific economic benefit amount.

Example 14. The facts are the same as in example 12, except that dividends received from corporations engaged in the exploitation of mineral K in country Y are subject to a 10 percent withholding tax (the ''10 percent withholding tax''). Thus, *C*'s liability

under the 75 percent levy is 75u, and *D*'s liability under the 10 percent withholding tax on the 25u distribution is 2.5u.

The only difference between the withholding tax and the 10 percent withholding tax applicable only to dual capacity taxpayers (including *D*) is that a lower rate (but the same base) applies to dual capacity taxpayers. Although the withholding tax and the 10 percent withholding tax are together a single levy, this difference makes it necessary, when dealing with multiple levies, to incorporate the withholding tax and *D*'s payment pursuant to the 10 percent withholding tax in the safe harbor formula. Accordingly, as in example 12, the safe harbor formula is applied by aggregation.

The aggregate effective rate of the general taxes for purposes of the safe harbor formula is .60 (.50 + [(1 − .50) × .20]). Pursuant to paragraph (e)(7), the aggregate actual payment amount of the qualifying levies for purposes of the formula is the sum of *C* and *D*'s liability for the 75 percent levy and the 10 percent withholding tax. Accordingly, under the safe harbor formula, the aggregate qualifying amount with respect to the 75 percent levy on *C* and the 10 percent withholding tax on *D* is 33.75u ((120u − 20u − [75u + 2.5u]) × .60/(1 − .60)), which is the aggregate amount of tax that *C* and *D* would have paid if *C* had been subject to the country Y income tax and had paid out its entire amount remaining after payment of that tax to *D* as a dividend subject to the withholding tax.

Example 15. The facts are the same as in example 5, except that the rate of the country E income tax is 45 percent and a political subdivision of country E also imposes a levy, called the ''local tax,'' on all corporations subject to the country E income tax. The base of the local tax is the same as the base of the country E income tax; the rate is 10 percent.

The reasoning of example 5 with regard to the country E income tax as applied to *A* and *B*, respectively, applies equally with regard to the local tax as applied to *A* and *B*, respectively. Accordingly, the entire amount paid by *A* pursuant to each of the country E income tax and the local tax is an amount of income tax paid, and both the country E income tax as applied to *B* and the local tax as applied to *B* are qualifying levies.

Pursuant to paragraph (e)(7), in applying the safe harbor formula to *B*, ''A'' is the amount of *B*'s gross receipts as determined under the (identical) country E income tax and local tax as applied to *B*; ''B'' is the amount of *B*'s costs and expenses thereunder; and ''C'' is the sum of *B*'s actual payment amounts with respect to the two levies. Pursuant to paragraph (e)(7), in applying the safe harbor formula to *B*, *B*'s aggregate qualifying amount with respect to the two levies is limited to the amount determined in accordance with paragraph (e)(5) where ''D'' is the rate of tax specified in section 11(b)(5) of the Internal Revenue Code. Accordingly, ''D'' is .46, which is the lower of the aggregate rate (55 percent) of the qualifying levies or the section 11(b)(5) rate (46 percent). *B*'s aggregate qualifying amount is, therefore, identical to *B*'s qualifying amount in example 6, which is less than its aggregate actual payment amount, and the difference is *B*'s specific economic benefit amount.

(f) *Effective date.* The effective date of this section is as provided in § 1.901–2(h).

(Approved by the Office of Management and Budget under control number 1545–0746)

[T.D. 7918, 48 FR 46284, Oct. 12, 1983]

§ 1.901–3 Reduction in amount of foreign taxes on foreign mineral income allowed as a credit.

(a) *Determination of amount of reduction*—(1) *In general.* For purposes of determining the amount of taxes which are allowed as a credit under section 901(a) for taxable years beginning after December 31, 1969, the amount of any income, war profits, and excess profits taxes paid or accrued, or deemed to be paid under section 902, during the taxable year to any foreign country or possession of the United States with respect to foreign mineral income (as defined in paragraph (b) of this section) from sources within such country or possession shall be reduced by the amount, if any, by which—

(i) The smaller of—

(*a*) The amount of such foreign income, war profits, and excess profits taxes, or

(*b*) The amount of the tax which would be computed under chapter 1 of the Code for such year with respect to such foreign mineral income if the deduction for depletion were determined under section 611 without regard to the deduction for percentage depletion under section 613, exceeds

(ii) The amount of the tax computed under chapter 1 of the Code for such year with respect to such foreign mineral income.

The reduction required by this subparagraph must be made on a country-by-country basis whether the taxpayer uses for the taxable year the per-country limitation under section 904(a)(1), or the overall limitation under section

904(a)(2), on the amount of taxes allowed as credit under section 901(a).

(2) *Determination of amount of tax on foreign mineral income*—(i) *Foreign tax.* For purposes of subparagraph (1)(i)(*a*) of this paragraph, the amount of the income, war profits, and excess profits taxes paid or accrued during the taxable year to a foreign country or possession of the United States with respect to foreign mineral income from sources within such country or possession is an amount which is the greater of—

(*a*) The amount by which the total amount of the income, war profits, and excess profits taxes paid or accrued during the taxable year to such country or possession exceeds the amount of such taxes that would be paid or accrued for such year to such country or possession without taking into account such foreign mineral income, or

(*b*) The amount of the income, war profits, and excess profits taxes that would be paid or accrued to such country or possession if such foreign mineral income were the taxpayer's only income for the taxable year, except that in no case shall the amount so determined exceed the total of all income, war profits, and excess profits taxes paid or accrued during the taxable year to such country or possession. For such purposes taxes which are paid or accrued also include taxes which are deemed paid under section 902. In the case of a dividend described in paragraph (b)(2)(i) (*a*) of this section which is from sources within a foreign country or possession of the United States and is attributable in whole or in part to foreign mineral income, the amount of the income, war profits, and excess profits taxes deemed paid under section 902 during the taxable year to such country or possession with respect to foreign mineral income from sources within such country or possession is an amount which bears the same ratio to the amount of the income, war profits, and excess profits taxes deemed paid under section 902 during such year to such country or possession with respect to such dividend as the portion of the dividend which is attributable to foreign mineral income bears to the total dividend. For purposes of (*a*) and (*b*) of this subdivision, foreign mineral income is to be reduced by any credits, expenses, losses, and other deductions which are properly allocable to such income under the law of the foreign country or possession of the United States from which such income is derived.

(ii) *U.S. tax.* For purposes of subparagraph (1)(ii) of this paragraph, the amount of the tax computed under chapter 1 of the Code for the taxable year with respect to foreign mineral income from sources within a foreign country or possession of the United States is the greater of—

(*a*) The amount by which the tax under chapter 1 of the Code on the taxpayer's taxable income for the taxable year exceeds a tax determined under such chapter on the taxable income for such year determined without regard to such foreign mineral income, or

(*b*) The amount of tax that would be determined under chapter 1 of the Code if such foreign mineral income were the taxpayer's only income for the taxable year.

For purposes of this subdivision the tax is to be determined without regard to any credits against the tax and without taking into account any tax against which a credit is not allowed under section 901(a). For purposes of (*b*) of this subdivision, the foreign mineral income is to be reduced only by expenses, losses, and other deductions properly allocable under chapter 1 of the Code to such income and is to be computed without any deduction for personal exemptions under section 151 or 642(b).

(iii) *U.S. income tax computed without deduction allowed by section 613.* For purposes of subparagraph (1)(i)(*b*) of this paragraph, the amount of the tax which would be computed under chapter 1 of the Code (without regard to section 613) for the taxable year with respect to foreign mineral income from sources within a foreign country or possession of the United States is the amount of the tax on such income that would be computed under such chapter by using as the allowance for depletion cost depletion computed upon the adjusted depletion basis of the property. For purposes of this subdivision the tax is to be determined without regard to

any credits against the tax and without taking into account any tax against which credit is not allowed under section 901(a). If the greater tax with respect to the foreign mineral income under subdivision (ii) of this subparagraph is the tax determined under (*a*) of such subdivision, the tax determined for purposes of subparagraph (1)(i)(*b*) of this paragraph is to be determined by applying the principles of (*a*) (rather than of (*b*)) of subdivision (ii) of this subparagraph. On the other hand, if the greater tax with respect to the foreign mineral income under subdivision (ii) of this subparagraph is the tax determined under (*b*) of such subdivision, the tax determined for purposes of subparagraph (1)(i)(*b*) of this paragraph is to be determined by applying the principles of (*b*) (rather than of (*a*)) of subdivision (ii) of this subparagraph.

(3) *Special rules.* (i) The reduction required by this paragraph in the amount of taxes paid, accrued, or deemed to be paid to a foreign country or possession of the United States applies only where the taxpayer is allowed a deduction for percentage depletion under section 613 with respect to any part of his foreign mineral income for the taxable year from sources within such country or possession, whether or not such deduction is allowed with respect to the entire foreign mineral income from sources within such country or possession for such year.

(ii) For purposes of this section, the term ''foreign country'' or ''possession of the United States'' includes the adjacent continental shelf areas to the extent, and in the manner, provided by section 638(2) and the regulations thereunder.

(iii) The provisions of this section are to be applied before making any reduction required by section 1503(b) in the amount of income, war profits, and excess profits taxes paid or accrued to foreign countries or possessions of the United States by a Western Hemisphere trade corporation.

(iv) If a taxpayer chooses with respect to any taxable year to claim a credit under section 901 and has any foreign mineral income from sources within a foreign country or possession of the United States with respect to which the deduction under section 613 is allowed, he must attach to his return a schedule showing the computations required by subdivisions (i), (ii), and (iii) of subparagraph (2) of this paragraph.

(v) A taxpayer who has elected to use the overall limitation under section 904(a)(2) on the amount of the foreign tax credit for any taxable year beginning before January 1, 1970, may, for his first taxable year beginning after December 31, 1969, revoke his election without first securing the consent of the Commissioner. See paragraph (d) of § 1.904–1.

(b) *Foreign mineral income defined*—(1) *In general.* The term ''foreign mineral income'' means income (determined under chapter 1 of the Code) from sources within a foreign country or possession of the United States derived from—

(i) The extraction of minerals from mines, wells, or other natural deposits,

(ii) The processing of minerals into their primary products, or

(iii) The transportation, distribution, or sale of minerals or of the primary products derived from minerals.

Any income of the taxpayer derived from an activity described in either subdivision (i), (ii), or (iii) of this subparagraph is foreign mineral income, since it is not necessary that the taxpayer extract, process, and transport, distribute, or sell minerals or their primary products for the income derived from any such activity to be foreign mineral income. Thus, for example, an integrated oil company must treat as foreign mineral income from sources within a foreign country or possession of the United States all income from such sources derived from the production of oil, the refining of crude oil into gasoline, the distribution of gasoline to marketing outlets, and the retail sale of gasoline. Similarly, income from such sources from the refining, distribution, or marketing of fuel oil by the taxpayer is foreign mineral income, whether or not the crude oil was extracted by the taxpayer. In further illustration, income from sources within a foreign country or possession of the United States derived from the processing of minerals into their primary products by the taxpayer is foreign mineral income, whether or not

the minerals were extracted, or the primary products were sold, by the taxpayer. Section 901(e) and this section apply whether or not the extraction, processing, transportation, distribution, or selling of the minerals or primary products is done by the taxpayer. Thus, for example, an individual who derives royalty income from the extraction of oil from an oil well in a foreign country has foreign mineral income for purposes of this paragraph. Income from the manufacture, distribution, and marketing of petrochemicals is not foreign mineral income. Foreign mineral income is not limited to gross income from the property within the meaning of section 613(c) and § 1.613–3.

(2) *Income included in foreign mineral income*—(i) *In general.* Foreign mineral income from sources within a foreign country or possession of the United States includes, but is not limited to—

(*a*) Dividends from such sources, as determined under § 1.902–1(h)(1), received from a foreign corporation in respect of which taxes are deemed paid by the taxpayer under section 902, to the extent such dividends are attributable to foreign mineral income described in subparagraph (1) of this paragraph. The portion of such a dividend which is attributable to such income is that amount which bears the same ratio to the total dividend received as the earnings and profits out of which such dividend is paid that are attributable to foreign mineral income bear to the total earnings and profits out of which such dividend is paid. For such purposes, the foreign mineral income of a foreign corporation is its foreign mineral income described in this paragraph (including any dividends described in this (*a*) which are received from another foreign corporation), whether or not such income is derived from sources within the foreign country or possession of the United States in which, or under the laws of which, the former corporation is created or organized. A foreign corporation is considered to have no foreign mineral income for any taxable year beginning before January 1, 1970.

(*b*) Any section 78 dividend to which a dividend described in (*a*) of this subdivision gives rise, but only to the extent such section 78 dividend is deemed paid under paragraph (a)(2)(i) of this section with respect to foreign mineral income from sources within such country or possession and to the extent it is treated under of § 1.902–1(h)(1) as income from sources within such country or possession.

(*c*) Any amounts includible in income of the taxpayer under section 702(a) as his distributive share of the income of a partnership consisting of income described in subparagraph (1) of this paragraph.

(*d*) Any amounts includible in income of the taxpayer by virtue of section 652(a), 662(a), 671, 682(a), or 691(a), to the extent such amounts consist of income described in subparagraph (1) of this paragraph.

(ii) *Illustration.* The provisions of this subparagraph may be illustrated by the following example:

Example. (a) Throughout 1974, M, a domestic corporation, owns all the one class of stock of N, a foreign corporation which is not a less developed country corporation within the meaning of section 902(d). Both corporations use the calendar year as the taxable year. N is incorporated in foreign country Y. During 1974, N has income from sources within foreign country X, all of which is foreign mineral income. During 1974, N also has income from sources within country Y, none of which is foreign mineral income. N is taxed in each foreign country only on income derived from sources within that country. Neither country X nor country Y allows a credit against its tax for foreign income taxes. N pays a dividend of $40,000 to M for 1974. For purposes of section 902, the dividend is paid from earnings and profits for 1974.

(b) N's earnings and profits and taxes for 1974 are determined as follows:

Foreign mineral income from country X		$100,000
Less:		
Intangible drilling and development costs	$21,000	
Cost depletion	3,000	24,000
Taxable income from country X		76,000
Income tax rate of country X		× 50%
Tax paid to country X		38,000
Income from country Y		100,000
Less deductions		25,000
Taxable income from country Y		75,000
Income tax rate of country Y		× 60%
Tax paid to country Y		45,000
Total taxable income		151,000

Less total foreign income taxes	83,000
Total earnings and profits	68,000
Taxable income from foreign mineral income	76,000
Less: Tax paid on foreign mineral income	38,000
Earnings and profits from foreign mineral income	38,000

(c) For 1974, M has foreign mineral income from country Y of $49,636.68, determined in the following manner and by applying this section, § 1.78–1, and § 1.902–1(h)(1):

Portion of dividend from country Y attributable to foreign mineral income (subdivision (i)(*a*) of this subparagraph) ($40,000 × $38,000/$68,000)	$22,352.94
Foreign income tax deemed paid by M to country Y under section 902(a)(1) ($83,000 × $40,000/$68,000)	48,823.53
Foreign income tax deemed paid by M to country Y with respect to foreign mineral income from country Y (paragraph (a)(2)(i) of this section) ($48,823.53 × $22,352.94/$40,000)	27,283.74
Foreign mineral income from country Y:	
Dividend attributable to foreign mineral income from country Y	22,352.94
Sec. 78 dividend deemed paid with respect to foreign mineral income (subdivision (i)(*b*) of this subparagraph)	27,283.74
Total foreign mineral income	49,636.68

(c) *Limitations on foreign tax credit*—(1) *In general.* The reduction under section 901(e) and paragraph (a)(1) of this section in the amount of foreign taxes allowed as a credit under section 901(a) is to be made whether the per-country limitation under section 904(a)(1) or the overall limitation under section 904(a)(2) is used for the taxable year, but the reduction in the amount of foreign taxes allowed as a credit under section 901(a) must be made on a country-by-country basis before applying the limitation under section 904(a) to the reduced amount of taxes. If for the taxable year the separate limitation under section 904(f) applies to any foreign mineral income, that limitation must also be applied after making the reduction under section 901(e) and paragraph (a)(1) of this section.

(2) *Carrybacks and carryovers of excess tax paid*—(i) *In general.* Any amount by which (*a*) any income, war profits, and excess profits taxes paid or accrued, or deemed to be paid under section 902, during the taxable year to any foreign country or possession of the United States with respect to foreign mineral income from sources within such country or possession exceed (b) the reduced amount of such taxes as determined under paragraph (a)(1) of this section may not be deemed paid or accrued under section 904(d) in any other taxable year. See § 1.904–2(b)(2)(iii). However, to the extent such reduced amount of taxes exceeds the applicable limitation under section 904(a) for the taxable year it shall be deemed paid or accrued under section 904(d) in another taxable year as a carryback or carryover of an unused foreign tax. The amount so deemed paid or accrued in another taxable year is not, however, deemed paid or accrued with respect to foreign mineral income in such other taxable year. See § 1.904–2(c)(3).

(ii) *Carryovers to taxable years beginning after December 31, 1969.* Where, under the provisions of section 904(d), taxes paid or accrued, or deemed to be paid under section 902, to any foreign country or possession of the United States in any taxable year beginning before January 1, 1970, are deemed paid or accrued in one or more taxable years beginning after December 31, 1969, the amount of such taxes so deemed paid or accrued shall not be deemed paid or accrued with respect to foreign mineral income and shall not be reduced under section 901(e) and paragraph (a)(1) of this section.

(iii) *Carrybacks to taxable years beginning before January 1, 1970.* Where income, war profits, and excess profits taxes are paid or accrued, or deemed to be paid under section 902, to any foreign country or possession of the United States in any taxable year beginning after December 31, 1969, with respect to foreign mineral income from sources within such country or possession, they must first be reduced under section 901(e) and paragraph (a)(1) of this section before they may be deemed paid or accrued under section 904(d) in one or more taxable years beginning before January 1, 1970.

(d) *Illustrations.* The application of this section may be illustrated by the following examples, in which the surtax exemption provided by section 11(d) and the tax surcharge provided by section 51(a) are disregarded for purposes of simplification:

Example 1. (a) M, a domestic corporation using the calendar year as the taxable year, is an operator drilling for oil in foreign country W. For 1971, M's gross income under chapter 1 of the Code is $100,000, all of which

is foreign mineral income from a property in country W and is subject to the allowance for depletion. During 1971, M incurs intangible drilling and development costs of $15,000, which are currently deductible for purposes of the tax of both countries. Cost depletion amounts to $2,000 for purposes of the tax of both countries, and only cost depletion is allowed as a deduction under the law of country W. It is assumed that no other deductions are allowable under the law of either country. Based upon the facts assumed, the income tax paid to country W on such foreign mineral income is $41,500, and the U.S. tax on such income before allowance of the foreign tax credit is $30,240, determined as follows:

	U.S. tax	W tax
Foreign mineral income	$100,000	$100,000
Less:		
Intangible drilling and development costs	15,000	15,000
Cost depletion	.....	2,000
Percentage depletion (22% of $100,000, but not to exceed 50% of $85,000)	22,000	.....
Taxable income	63,000	83,000
Income tax rate	48%	50%
Tax	30,240	41,500

(b) Without taking this section into account, M would be allowed a foreign tax credit for 1971 of $30,240 ($30,240 × $63,000/$63,000), and foreign income tax in the amount of $11,260 ($41,500 less $30,240) would first be carried back to 1969 under section 904(d).

(c) Pursuant to paragraph (a)(1) of this section, however, the foreign income tax allowable as a credit against the U.S. tax is reduced to $31,900, determined as follows:

Foreign income tax paid on foreign mineral income		$41,500
Less reduction under sec. 901(e):		
Smaller of $41,500 (tax paid to country W on foreign mineral income) or $39,840 (U.S. tax on foreign mineral income of $83,000 ($83,000 × 48%), determined by deducting cost depletion of $2,000 in lieu of percentage depletion of $22,000)	39,840	
Less: U.S. tax on foreign mineral income (before credit)	$30,240	9,600
Foreign income tax allowable as a credit		31,900

(d) After taking this section into account, M is allowed a foreign tax credit for 1971 of $30,240 ($30,240 × $63,000/$63,000). The amount of foreign income tax which may be first carried back to 1969 under section 904(d) is reduced from $11,260 to $1,660 ($31,900 less $30,240).

Example 2. (a) M, a domestic corporation using the calendar year as the taxable year, is an operator drilling for oil in foreign country X. For 1972, M has gross income under chapter 1 of the Code of $100,000, all of which is foreign mineral income from a property in country X and is subject to the allowance for depletion. During 1972, M incurs intangible drilling and development costs of $50,000 which are currently deductible for purposes of the U.S. tax but which must be amortized for purposes of the tax of country X. Percentage depletion of $22,000 is allowed as a deduction by both countries. For purposes of the U.S. tax, cost depletion for 1972 amounts to $15,000. It is assumed that no other deductions are allowable under the law of either country. Based upon these facts, the income tax paid to country X on such foreign mineral income is $27,200, and the U.S. tax on such income before allowance of the foreign tax credit is $13,440, determined as follows:

	U.S. tax	X tax
Foreign mineral income	$100,000	$100,000
Less:		
Intangible drilling and development costs	50,000	10,000
Percentage depletion	22,000	22,000
Taxable income	28,000	68,000
Income tax rate	48%	40%
Tax	13,440	27,200

(b) Without taking this section into account, M would be allowed a foreign tax credit for 1972 of $13,440 ($13,440 × $28,000/$28,000), and foreign income tax in the amount of $13,760 ($27,200 less $13,440) would first be carried back to 1970 under section 904(d).

(c) Pursuant to paragraph (a)(1) of this section, however, the foreign income tax allowable as a credit against the U.S. tax is reduced to $23,840, determined as follows:

Foreign income tax paid on foreign mineral income		$27,200
Less reduction under sec. 901(e):		
Smaller of $27,200 (tax paid to country X on foreign mineral income) or $16,800 (U.S. tax on foreign mineral income of $35,000 ($35,000 × 48%), determined by deducting cost depletion of $15,000 in lieu of percentage depletion of $22,000)	$16,800	
Less: U.S. tax on foreign mineral income (before credit)	13,440	3,360
Foreign income tax allowable as a credit		23,840

(d) After taking this section into account, M is allowed a foreign tax credit of $13,440 ($13,440 × $28,000/$28,000). The amount of foreign income tax which may be first carried back to 1970 under section 904(d) is reduced from $13,760 to $10,400 ($23,840 less $13,440).

Example 3. (a) N, a domestic corporation using the calendar year as the taxable year, is an operator drilling for oil in foreign country Y. For 1972, N's gross income under chapter 1 of the Code is $100,000, all of which is foreign mineral income from a property in country Y and is subject to the allowance for depletion. During 1972, N incurs intangible drilling and development costs of $15,000, which are currently deductible for purposes

of the U.S. tax but are not deductible under the law of country Y. Depreciation of $40,000 is allowed as a deduction for purposes of the U.S. tax; and of $20,000, for purposes of the Y tax. Cost depletion amounts to $10,000 for purposes of the tax of both countries, and only cost depletion is allowed as a deduction under the law of country Y. It is assumed that no other deductions are allowable under the law of either country. Based upon the facts assumed, the income tax paid to country Y on such foreign mineral income is $14,000, and the U.S. tax on such income before allowance of the foreign tax credit is $11,040, determined as follows:

	U.S. tax	Y tax
Foreign mineral income	$100,000	$100,000
Less:		
Intangible drilling and development costs	15,000	.....
Depreciation	40,000	20,000
Cost depletion	.....	10,000
Percentage depletion (22% of $100,000, but not to exceed 50% of $45,000)	22,000	.....
Taxable income	23,000	70,000
Income tax rate	48%	20%
Tax	11,040	14,000

(b) Without taking this section into account, N would be allowed a foreign tax credit for 1972 of $11,040 ($11,040 × $23,000/$23,000), and foreign income tax in the amount of $2,960 ($14,000 less $11,040) would first be carried back to 1970 under section 904(d).

(c) Pursuant to paragraph (a)(1) of this section, however, the foreign income tax allowable as a credit against the U.S. tax is reduced to $11,040, determined as follows:

Foreign income tax paid on foreign mineral income		$14,000
Less reduction under sec. 901(e):		
Smaller of $14,000 (tax paid to country Y on foreign mineral income) or $16,800 (U.S. tax on foreign mineral income of $35,000 ($35,000 × 48%), determined by deducting cost depletion of $10,000 in lieu of percentage depletion of $22,000)	$14,000	
Less: U.S. tax on foreign mineral income (before credit)	11,040	2,960
Foreign income tax allowable as a credit		11,040

(d) After taking this section into account, N is allowed a foreign tax credit for 1972 of $11,040 ($11,040 × $23,000/$23,000), but no foreign income tax is carried back to 1970 under section 904(d) since the allowable credit of $11,040 does not exceed the limitation of $11,040.

Example 4. (a) D, a domestic corporation using the calendar year as the taxable year, is an operator drilling for oil in foreign country Z. For 1971, D's gross income under chapter 1 of the Code is $100,000, all of which is foreign mineral income from a property in country Z and is subject to the allowance for depletion. During 1971, D incurs intangible drilling and development costs of $85,000, which are currently deductible for purposes of the U.S. Tax but are not deductible under the law of country Z. Cost depletion in the amount of $10,000 is allowed as a deduction for purposes of both the U.S. tax and the tax of country Z. Percentage depletion is not allowed as a deduction under the law of country Z and is not taken as a deduction for purposes of the U.S. tax. It is assumed that no other deductions are allowable under the law of either country. Based upon the facts assumed, the income tax paid to country Z on such foreign mineral income is $27,000, and the U.S. tax on such income before allowance of the foreign tax credit is $2,400, determined as follows:

	U.S. tax	Z tax
Foreign mineral income	$100,000	$100,000
Less:		
Intangible drilling and development costs	85,000	.....
Cost depletion	10,000	10,000
Taxable income	5,000	90,000
Income tax rate	48%	30%
Tax	2,400	27,000

(b) Section 901(e) and this section do not apply to reduce the amount of the foreign income tax paid to country Z with respect to the foreign mineral income since for 1971 D is not allowed the deduction for percentage depletion with respect to any foreign mineral income from sources within country Z. Accordingly, D is allowed a foreign tax credit of $2,400 ($2,400 × $5,000/$5,000), and foreign income tax in the amount of $24,600 ($27,000 less $2,400) is first carried back to 1969 under section 904(d).

Example 5. (a) R, a domestic corporation using the calendar year as the taxable year, is an operator drilling for oil in the United States and in foreign country Z. For 1971, R's gross income under chapter 1 of the Code is $250,000, of which $100,000 is foreign mineral income from a property in foreign country Z and $150,000 is from a property in the United States, all being subject to the allowance for depletion. During 1971, R incurs intangible drilling and development costs of $125,000 in the United States and of $25,000 in country Z, all of which are currently deductible for purposes of the U.S. tax. Of these costs of $25,000 incurred in country Z, only $2,500 is currently deductible under the law of country Z. Cost depletion in the case of the U.S. property amounts to $60,000; and in the case of the property in country Z, to $5,000, which is allowed as a deduction under the laws of such country. Percentage depletion is not allowed as a deduction under the law of country Z. In computing the U.S. tax for 1971, R is required to use cost depletion with respect to the mineral income from the U.S. property and percentage depletion with respect

to the foreign mineral income from the property in country Z. It is assumed that no other deductions are allowed under the law of either country. Based upon the facts assumed, the income tax paid to country Z on the foreign mineral income from sources therein is $37,000, and the U.S. tax on the entire mineral income before allowance of the foreign tax credit is $8,640, determined as follows:

	U.S. tax	Z tax
Gross income (including foreign mineral income)	$250,000	$100,000
Less:		
Intangible drilling and development costs	150,000	2,500
Cost depletion	60,000	5,000
Percentage depletion on foreign mineral income (22% of $100,000, but not to exceed 50% of [$100,000 − $25,000])	22,000	.....
Taxable income	18,000	92,500
Income tax rate	48%	40%
Tax	8,640	37,000

(b) Without taking this section into account, R would be allowed a foreign tax credit for 1971 of $8,640 ($8,640 × $18,000/$18,000), and foreign income tax in the amount of $28,360 ($37,000 less $8,640) would first be carried back to 1969 under section 904(d).

(c) Under paragraph (a)(2)(ii) of this section, the amount of the U.S. tax for 1971 with respect to foreign mineral income from country Z is $25,440, which is the greater of the amounts of tax determined under subparagraphs (1) and (2):

(1) U.S. tax on total taxable income in excess of U.S. tax on taxable income excluding foreign mineral income from country Z (determined under paragraph (a)(2)(ii)(*a*) of this section):

U.S. tax on total taxable income	.....	$8,640
Less U.S. tax on taxable income other than foreign mineral income from country Z:		
Income from U.S. property	$150,000	
Intangible drilling and development costs	125,000	
Cost depletion	60,000	
Taxable income	0	
Income tax rate	48%	
U.S. tax	0	0
Excess tax	.....	8,640

(2) U.S. tax on foreign mineral income from country Z (determined under paragraph (a)(2)(ii) (*b*) of this section):

Foreign mineral income	$100,000
Intangible drilling and development costs	25,000
Percentage depletion (22% of $100,000, but not to exceed 50% of $75,000)	22,000
Taxable income	53,000
Income tax rate	48%
U.S. tax	25,440

(d) Under paragraph (a)(2)(iii) of this section, the amount of the U.S. tax which would be computed for 1971 (without regard to section 613) with respect to foreign mineral income from sources within country Z is $33,600, computed by applying the principles of paragraph (a)(2)(ii)(*b*) of this section:

Foreign mineral income	$100,000
Intangible drilling and development costs	25,000
Cost depletion	5,000
Taxable income	70,000
Income tax rate	48%
U.S. tax	33,600

(e) Pursuant to paragraph (a)(1) of this section, the foreign income tax allowable as a credit against the U.S. tax for 1971 is reduced to $28,840, determined as follows:

Foreign income tax paid on foreign mineral income		$37,000
Less reduction under sec. 901(e):		
Smaller of $37,000 (tax paid to country Z on foreign mineral income) or $33,600 (U.S. tax on foreign mineral income of $70,000, as determined under paragraph (d) of this example	$33,600	
Less: U.S. tax on foreign mineral income of $53,000, as determined under paragraph (c) of this example	25,440	8,160
Foreign income tax allowable as a credit		$28,840

(f) After taking this section into account, R is allowed a foreign tax credit for 1971 of $8,640 ($8,640 × $18,000/$18,000). The amount of foreign income tax which may be first carried back to 1969 under section 904(d) is reduced from $28,360 to $20,200 ($28,840 less $8,640).

Example 6. (a) B, a single individual using the calendar year as the taxable year, is an operator drilling for oil in foreign countries X and Y. For 1972, B's gross income under chapter 1 of the Code is $250,000, of which $150,000 is foreign mineral income from a property in country X and $100,000 is foreign mineral income from a property in country Y, all being subject to the allowance for depletion. The assumption is made that B's earned taxable income for 1972 is insufficient to cause section 1348 to apply. During 1972, B incurs intangible drilling and development costs of $16,000 in country X and of $9,000 in country Y, which are currently deductible for purposes of both the U.S. tax and the tax of countries X and Y, respectively. For purposes of both the U.S. tax and the tax of countries X and Y, respectively, cost depletion in the case of the X property amounts to $8,000, and in the case of Y property, to $7,000; and only cost depletion is allowed as a deduction under the law of countries X and Y. For 1972, B uses the overall limitation under section 904(a)(2) on the foreign tax credit. Percentage depletion is not allowed as a deduction under the law of countries X and Y. It is assumed that the only other allowable deductions amount to $2,250. None of these deductions is attributable to the income from the properties in countries X and Y, and none is deductible under the laws of country X or country Y. Based upon the

facts assumed, the income tax paid to countries X and Y on the foreign mineral income from each such country is $71,820 and $25,200, respectively, and the U.S. tax on B's total taxable income before allowance of the foreign tax credit is $99,990, determined as follows:

	U.S. Tax	X tax	Y tax
Total income (including foreign mineral income from countries X and Y)	$250,000	$150,000	$100,000
Intangible drilling and development costs	25,000	16,000	9,000
Cost depletion	.....	8,000	7,000
Percentage depletion (22% of $150,000, but not to exceed 50% of $134,000; plus 22% of $100,000, but not to exceed 50% of $91,000)	55,000	.....	.....
Adjusted gross income	170,000	.....	.....
Other deductions	2,250	.....	.....
Personal exemption	750	.....	.....
Taxable income	167,000	126,000	84,000
Income tax rate	.....	57%	30%
Foreign tax	.....	71,820	25,200
U.S. tax ($53,090 plus 70% of $67,000)	99,990	.....	.....

(b) Without taking this section into account, B would be allowed a foreign tax credit for 1972 of $97,020 ($71,820 + $25,200), but not to exceed the overall limitation under section 904(a)(2) of $99,990 ($99,990 × $167,750/$167,750). There would be no foreign income tax carried back to 1970 under section 904(d) since the allowable credit of $97,020 does not exceed the limitation of $99,990.

(c) Under paragraph (a)(2)(ii) of this section, the amount of the U.S. tax for 1972 with respect to foreign mineral income from sources within country X is $69,760, which is the greater of the amounts of tax determined under subparagraphs (1) and (2):

(1) U.S. tax on total taxable income in excess of U.S. tax on taxable income excluding foreign mineral income from country X (determined under paragraph (a)(2)(ii)(*a*) of this section):

U.S. tax on total taxable income	.....	$99,990
Less U.S. tax on taxable income other than foreign mineral income from country X:		
Foreign mineral income from country Y	$100,000	
Intangible drilling and development costs	9,000	
Percentage depletion (22% of $100,000, but not to exceed 50% of $91,000)	22,000	
Adjusted gross income	69,000	
Other deductions	2,250	
Personal exemption	750	
Taxable income	66,000	
U.S. tax ($26,390 plus 64% of $6,000)	.....	30,230
Excess tax	.....	69,760

(2) U.S. tax on foreign mineral income from country X (determined under paragraph (a)(2)(ii)(*b*) of this section):

Foreign mineral income from country X	$150,000.00
Intangible drilling and development costs	16,000.00
Percentage depletion (22% of $150,000, but not to exceed 50% of $134,000)	33,000.00
Adjusted gross income	101,000.00
Other deductions.	
Taxable income	101,000.00
U.S. tax ($53,090 plus 70% of excess over $100,000)	53,790.00

(d) Under paragraph (a)(2)(iii) of this section, and by applying the principles of paragraph (a)(2)(ii)(*a*) of this section, the amount of the U.S. tax which would be computed for 1972 (without regard to section 613) with respect to foreign mineral income from sources within country X is $87,920, which is the excess of the U.S. tax ($127,990) determined under subparagraph (1) over the U.S. tax ($40,070) determined under subparagraph (2):

(1) U.S. tax on total taxable income determined without regard to section 613:

Total income	$250,000
Intangible drilling and development costs	25,000
Cost depletion	15,000
Adjusted gross income	210,000
Other deductions	2,250
Personal exemption	750
Taxable income	207,000
U.S. tax ($53,090 plus 70% of $107,000)	127,990

(2) U.S. tax on total taxable income other than foreign mineral income from country X, determined without regard to section 613:

Foreign mineral income from country Y	$100,000
Intangible drilling and development costs	9,000
Cost depletion	7,000
Adjusted gross income	84,000
Other deductions	2,250
Personal exemption	750
Taxable income	81,000
U.S. tax ($39,390 plus 68% of $1,000)	40,070

(e) Under paragraph (a)(2)(i) of this section, the amount of income tax paid to country X for 1972 with respect to foreign mineral income from sources within such country is $71,820. This is the amount determined under both (*a*) and (*b*) of paragraph (a)(2)(i) of this section, since, in this case, there is no income from sources within country X other than foreign mineral income, and there are no deductions allowed under the law of country X which are not allocable to such foreign mineral income.

(f) Pursuant to paragraph (a)(1) of this section, the foreign income tax with respect to foreign mineral income from sources within country X which is allowable as a credit against the U.S. tax for 1972 is reduced to $69,760, determined as follows:

Foreign income tax paid to country X on foreign mineral income	$71,820

Less reduction under sec. 901(e):		
Smaller of $71,820 (tax paid to country X on foreign mineral income) or $87,920 (U.S. tax on foreign mineral income from sources within country X, as determined under paragraph (d) of this example)	$71,820	
Less: U.S. tax on foreign mineral income from sources within country X, determined under paragraph (c) of this example	69,760	2,060
Foreign income tax of country X allowable as a credit		69,760

(g) Under paragraph (a)(2)(ii) of this section, the amount of the U.S. tax for 1972 with respect to foreign mineral income from sources within country Y is $48,280, which is the greater of the amounts of tax determined under subparagraphs (1) and (2):

(1) U.S. tax on total taxable income in excess of U.S. tax on taxable income excluding foreign mineral income from country Y (determined under paragraph (a)(2)(ii)(*a*) of this section):

U.S. tax on total taxable income		$99,990
Less U.S. tax on taxable income other than foreign mineral income from country Y:		
Foreign mineral income from country X	$150,000	
Intangible drilling and development costs	16,000	
Percentage depletion (22% of $150,000, but not to exceed 50% of $134,000)	33,000	
Adjusted gross income	101,000	
Other deductions	2,250	
Personal exemption	750	
Taxable income	98,000	
U.S. tax ($46,190 plus 69% of $8,000)		51,710
Excess tax		48,280

(2) U.S. tax on foreign mineral income from country Y (determined under paragraph (a)(2)(ii)(*b*) of this section):

Foreign mineral income from country Y	$100,000
Intangible drilling and development costs	9,000
Percentage depletion (22% of $100,000, but not to exceed 50% of $91,000)	22,000
Adjusted gross income	69,000
Other deductions	
Taxable income	69,000
U.S. tax ($26,390 plus 64% of $9,000)	32,150

(h) Under paragraph (a)(2)(iii) of this section, and by applying the principles of paragraph (a)(2)(ii)(*a*) of this section, the amount of the U.S. tax which would be computed for 1972 (without regard to section 613) with respect to foreign mineral income from sources within country Y is $58,800, which is the excess of the U.S. tax ($127,990) determined under paragraph (d)(1) of this example over the U.S. tax ($69,190) on total taxable income other than foreign mineral income from country Y, determined without regard to section 613, as follows:

Foreign mineral income from country X	$150,000
Intangible drilling and development costs	16,000
Cost depletion	8,000
Adjusted gross income	126,000
Other deductions	2,250
Personal exemption	750
Taxable income	123,000
U.S. tax ($53,090 plus 70% of $23,000)	69,190

(i) Under paragraph (a)(2)(i) of this section, the amount of income tax paid to country Y for 1972 with respect to foreign mineral income from sources within such country is $25,200. This is the amount determined under both (*a*) and (*b*) of paragraph (a)(2)(i) of this section, since, in this case, there is no income from sources within country Y other than foreign mineral income, and there are no deductions allowed under the law of country Y which are not allocable to such foreign mineral income.

(j) Pursuant to paragraph (a)(1) of this section, the foreign income tax with respect to foreign mineral income from sources within country Y which is allowable as a credit against the U.S. tax for 1972 is not reduced from $25,200, as follows:

Foreign income tax paid to country Y on foreign mineral income		$25,200
Less reduction under sec. 901(e):		
Smaller of $25,200 (tax paid to country Y on foreign mineral income) or $58,800 (U.S. tax on foreign mineral income from sources within country Y, as determined under paragraph (h) of this example)	$25,200	
Less: U.S. tax on foreign mineral income from sources within country Y, as determined under paragraph (g) of this example	48,280	
Foreign income tax of country Y allowable as a credit		25,200

(k) After taking this section into account, B is allowed a foreign tax credit for 1972 of $94,960 ($69,760 + $25,200), but not to exceed the overall limitation under section 904 (a)(2) of $99,990 ($99,990 × $167,750/$167,750). There would be no foreign income tax carried back to 1970 under section 904(d) since the allowable credit of $94,960 does not exceed the limitation of $99,990.

Example 7. (a) P, a domestic corporation using the calendar year as the taxable year, is an operator mining for iron ore in foreign country X. For 1971, P's gross income under chapter 1 of the Code is $100,000, all of which is foreign mineral income from a property in country X and is subject to the allowance for depletion. For 1971, cost depletion amounts to $5,000 for purposes of the tax of both countries, and only cost depletion is allowed as a deduction under the law of country X. It is assumed that deductions (other than for depletion) attributable to the mineral property in country X amount to $8,000, and these deductions are allowable under the law of both countries. Based upon the facts assumed, the income tax paid to country X on such foreign mineral income is $39,150, and the U.S. tax

on such income before allowance of the foreign tax credit is $37,440 determined as follows:

	U.S. tax	X tax
Foreign mineral income	$100,000	$100,000
Less:		
Percentage depletion (14% of $100,000, but not to exceed 50% of $92,000)	14,000	.....
Cost depletion	.....	5,000
Other deductions	8,000	8,000
Taxable income	78,000	87,000
Income tax rate	48%	45%
Tax	37,440	39,150

(b) Without taking this section into account, P would be allowed a foreign tax credit for 1971 of $37,440 ($37,440 × $78,000/ $78,000), and foreign income tax in the amount of $1,710 ($39,150 less $37,440) would first be carried back to 1969 under section 904(d).

(c) Pursuant to paragraph (a)(1) of this section, however, the foreign income tax allowable as a credit against the U.S. tax is reduced to $37,440, determined as follows:

Foreign income tax paid on foreign mineral income		$39,150
Less reduction under sec. 901(e):		
Smaller of $39,150 (tax paid to country X on foreign mineral income) or $41,760 (U.S. tax on foreign mineral income of $87,000 ($87,000 × 48%), determined by deducting cost depletion of $5,000 in lieu of percentage depletion of $14,000)	$39,150	
Less: U.S. tax on foreign mineral income (before credit)	37,440	1,710
Foreign income tax allowable as a credit		37,440

(d) After taking this section into account, P is allowed a foreign tax credit for 1971 of $37,440 ($37,440 × $78,000/$78,000), but no foreign income tax is carried back to 1969 under section 904(d) since the allowable credit of $37,440 does not exceed the limitation of $37,440.

Example 8. (a) The facts are the same as in example 7, except that P is assumed to have received dividends for 1971 of $25,000 from R, a foreign corporation incorporated in country X which is not a less developed country corporation within the meaning of section 902(d). Income tax of $2,500 ($25,000 × 10%) on such dividends is withheld at the source in country X. It is assumed that P is deemed under section 902(a)(1) and § 1.902–1(h) to have paid income tax of $22,500 to country X in respect of such dividends and that under paragraphs (a)(2)(i) and (b)(2)(i) of this section such dividends are deemed to be attributable to foreign mineral income from sources in country X and that such tax is deemed to be paid with respect to such foreign mineral income. Based upon the facts assumed, the U.S. tax on the foreign mineral income from sources in country X is $60,240 before allowance of the foreign tax credit, determined as follows:

Foreign mineral income from country X:		
Income from mining property	$100,000	
Dividends from R	25,000	
Sec. 78 dividend	22,500	$147,500
Less:		
Percentage depletion (14% of $100,000, but not to exceed 50% of $92,000)		$14,000
Other deductions		8,000
Taxable income		125,500
Income tax rate		48%
U.S. tax		60,240

(b) Without taking this section into account, P would be allowed a foreign tax credit for 1971 of $60,240 ($60,240 × $125,500/$125,500), and foreign income tax in the amount of $3,910 ([$39,150 + $22,500 + $2,500] less $60,240) would first be carried back to 1969 under section 904(d).

(c) Pursuant to paragraph (a)(1) of this section, however, the foreign income tax allowable as a credit against the U.S. tax is reduced from $64,150 to $60,240, determined as follows:

Foreign income tax paid, and deemed to be paid, to country X on foreign mineral income ($39,150 + $22,500 + $2,500)		$64,150
Less reduction under sec. 901(e):		
Smaller of $64,150 (tax paid and deemed paid to country X on foreign mineral income) or $64,560 (U.S. tax on foreign mineral income of $134,500 ($134,500 × 48%), determined by deducting cost depletion of $5,000 in lieu of percentage depletion of $14,000)	$64,150	
Less: U.S. tax on foreign mineral income (before credit)	$60,240	$3,910
Foreign income tax allowable as a credit		60,240

(d) After taking this section into account, P is allowed a foreign tax credit for 1971 of $60,240 ($60,240 × $125,500/$125,500), but no foreign income tax is carried back to 1969 under section 904(d) since the allowable credit of $60,240 does not exceed the limitation of $60,240.

[T.D. 7294, 38 FR 33074, Nov. 30, 1973, as amended by T.D. 7481, 42 FR 20130, Apr. 18, 1977]

§ 1.902–0 Outline of regulations provisions for section 902.

This section lists the provisions under section 902.

§ 1.902–1 Credit for domestic corporate shareholder of a foreign corporation for foreign income taxes paid by the foreign corporation.

(a) Definitions and special effective date.
(1) Domestic shareholder.
(2) First-tier corporation.
(3) Second-tier corporation.
(4) Third- or lower-tier corporation.

(i) Third-tier corporation.
(ii) Fourth-, fifth-, or sixth-tier corporation.
(5) Example.
(6) Upper- and lower-tier corporations.
(7) Foreign income taxes.
(8) Post-1986 foreign income taxes.
(i) In general.
(ii) Distributions out of earnings and profits accumulated by a lower-tier corporation in its taxable years beginning before January 1, 1987, and included in the gross income of an upper-tier corporation in its taxable year beginning after December 31, 1986.
(iii) Foreign income taxes paid or accrued with respect to high withholding tax interest.
(9) Post-1986 undistributed earnings.
(i) In general.
(ii) Distributions out of earnings and profits accumulated by a lower-tier corporation in its taxable years beginning before January 1, 1987, and included in the gross income of an upper-tier corporation in its taxable year beginning after December 31, 1986.
(iii) Reduction for foreign income taxes paid or accrued.
(iv) Special allocations.
(10) Pre-1987 accumulated profits.
(i) Definition.
(ii) Computation of pre-1987 accumulated profits.
(iii) Foreign income taxes attributable to pre-1987 accumulated profits.
(11) Dividend.
(12) Dividend received.
(13) Special effective date.
(i) Rule.
(ii) Example.
(b) Computation of foreign income taxes deemed paid by a domestic shareholder, first-tier corporation, or lower-tier corporation.
(1) General rule.
(2) Allocation rule for dividends attributable to post-1986 undistributed earnings and pre-1987 accumulated profits.
(i) Portion of dividend out of post-1986 undistributed earnings.
(ii) Portion of dividend out of pre-1987 accumulated profits.
(3) Dividends paid out of pre-1987 accumulated profits.
(4) Deficits in accumulated earnings and profits.
(5) Examples.
(c) Special rules.
(1) Separate computations required for dividends from each first-tier and lower-tier corporation.
(i) Rule.
(ii) Example.
(2) Section 78 gross-up.
(i) Foreign income taxes deemed paid by a domestic shareholder.
(ii) Foreign income taxes deemed paid by an upper-tier corporation.
(iii) Example.
(3) Creditable foreign income taxes.
(4) Foreign mineral income.
(5) Foreign taxes paid or accrued in connection with the purchase or sale of certain oil and gas.
(6) Foreign oil and gas extraction income.
(7) United States shareholders of controlled foreign corporations.
(8) Effect of certain liquidations, reorganizations, or similar transactions on certain foreign taxes paid or accrued in taxable years beginning on or before August 5, 1997.
(i) General rule.
(ii) Example.
(d) Dividends from controlled foreign corporations and noncontrolled section 902 corporations.
(1) General rule.
(2) Look-through.
(i) Dividends.
(ii) Coordination with section 960.
(e) Information to be furnished.
(f) Examples.
(g) Effective date.

§ 1.902–2 Treatment of deficits in post-1986 undistributed earnings and pre-1987 accumulated profits of a first- or lower-tier corporation for purposes of computing an amount of foreign taxes deemed paid under § 1.902–1.

(a) Carryback of deficits in post-1986 undistributed earnings of a first- or lower-tier corporation to pre-effective date taxable years.
(1) Rule.
(2) Examples.
(b) Carryforward of deficit in pre-1987 accumulated profits of a first- or lower-tier corporation to post-1986 undistributed earnings for purposes of section 902.
(1) General rule.
(2) Effect of pre-effective date deficit.
(3) Examples.

§ 1.902–3 Credit for domestic corporate shareholder of a foreign corporation for foreign income taxes paid with respect to accumulated profits of taxable years of the foreign corporation beginning before January 1, 1987.

(a) Definitions.
(1) Domestic shareholder.
(2) First-tier corporation.
(3) Second-tier corporation.
(4) Third-tier corporation.
(5) Foreign income taxes.
(6) Dividend.
(7) Dividend received.
(b) Domestic shareholder owning stock in a first-tier corporation.
(1) In general.
(2) Amount of foreign taxes deemed paid by a domestic shareholder.
(c) First-tier corporation owning stock in a second-tier corporation.
(1) In general.
(2) Amount of foreign taxes deemed paid by a first-tier corporation.

(d) Second-tier corporation owning stock in a third-tier corporation.
(1) In general.
(2) Amount of foreign taxes deemed paid by a second-tier corporation.
(e) Determination of accumulated profits of a foreign corporation.
(f) Taxes paid on or with respect to accumulated profits of a foreign corporation.
(g) Determination of earnings and profits of a foreign corporation.
(1) Taxable year to which section 963 does not apply.
(2) Taxable year to which section 963 applies.
(3) Time and manner of making choice.
(4) Determination by district director.
(h) Source of income from first-tier corporation and country to which tax is deemed paid.
(1) Source of income.
(2) Country to which taxes deemed paid.
(i) United Kingdom income taxes paid with respect to royalties.
(j) Information to be furnished.
(k) Illustrations.
(l) Effective date.

§ 1.902–4 Rules for distributions attributable to accumulated profits for taxable years in which a first-tier corporation was a less developed country corporation.

(a) In general.
(b) Combined distributions.
(c) Distributions of a first-tier corporation attributable to certain distributions from second- or third-tier corporations.
(d) Illustrations.

[T.D. 8708, 62 FR 927, Jan. 7, 1997, as amended by T.D. 9260, Apr. 25, 2006]

§ 1.902–1 Credit for domestic corporate shareholder of a foreign corporation for foreign income taxes paid by the foreign corporation.

(a) *Definitions and special effective date.* For purposes of section 902, this section, and § 1.902–2, the definitions provided in paragraphs (a) (1) through (12) of this section and the special effective date of paragraph (a)(13) of this section apply.

(1) *Domestic shareholder.* In the case of dividends received by a domestic corporation from a foreign corporation after December 31, 1986, the term domestic shareholder means a domestic corporation, other than an S corporation as defined in section 1361(a), that owns at least 10 percent of the voting stock of the foreign corporation at the time the domestic corporation receives a dividend from that foreign corporation.

(2) *First-tier corporation.* In the case of dividends received by a domestic shareholder from a foreign corporation in a taxable year beginning after December 31, 1986, the term first-tier corporation means a foreign corporation, at least 10 percent of the voting stock of which is owned by a domestic shareholder at the time the domestic shareholder receives a dividend from that foreign corporation. The term first-tier corporation also includes a DISC or former DISC, but only with respect to dividends from the DISC or former DISC that are treated under sections 861(a)(2)(D) and 862(a)(2) as income from sources without the United States.

(3) *Second-tier corporation.* In the case of dividends paid to a first-tier corporation by a foreign corporation in a taxable year beginning after December 31, 1986, the foreign corporation is a second-tier corporation if, at the time a first-tier corporation receives a dividend from that foreign corporation, the first-tier corporation owns at least 10 percent of the foreign corporation's voting stock and the product of the following equals at least 5 percent—

(i) The percentage of voting stock owned by the domestic shareholder in the first-tier corporation; multiplied by

(ii) The percentage of voting stock owned by the first-tier corporation in the second-tier corporation.

(4) *Third- or lower-tier corporation.*—(i) *Third-tier corporation.* In the case of dividends paid to a second-tier corporation by a foreign corporation in a taxable year beginning after December 31, 1986, a foreign corporation is a third-tier corporation if, at the time a second-tier corporation receives a dividend from that foreign corporation, the second-tier corporation owns at least 10 percent of the foreign corporation's voting stock and the product of the following equals at least 5 percent—

(A) The percentage of voting stock owned by the domestic shareholder in the first-tier corporation; multiplied by

(B) The percentage of voting stock owned by the first-tier corporation in the second-tier corporation; multiplied by

(C) The percentage of voting stock owned by the second-tier corporation in the third-tier corporation.

(ii) *Fourth-, fifth-, or sixth-tier corporation.* In the case of dividends paid to a third-, fourth-, or fifth-tier corporation by a foreign corporation in a taxable year beginning after August 5, 1997, the foreign corporation is a fourth-, fifth-, or sixth-tier corporation, respectively, if at the time the dividend is paid, the corporation receiving the dividend owns at least 10 percent of the foreign corporation's voting stock, the chain of foreign corporations that includes the foreign corporation is connected through stock ownership of at least 10 percent of their voting stock, the domestic shareholder in the first-tier corporation in such chain indirectly owns at least 5 percent of the voting stock of the foreign corporation through such chain, such corporation is a controlled foreign corporation (as defined in section 957) and the domestic shareholder is a United States shareholder (as defined in section 951(b)) in the foreign corporation. Taxes paid by a fourth-, fifth-, or sixth-tier corporation shall be taken into account in determining post-1986 foreign income taxes only if such taxes are paid with respect to taxable years beginning after August 5, 1997, in which the corporation was a controlled foreign corporation.

(5) *Example.* The following example illustrates the ownership requirements of paragraphs (a) (1) through (4) of this section:

Example. (i) Domestic corporation M owns 30 percent of the voting stock of foreign corporation A on January 1, 1991, and for all periods thereafter. Corporation A owns 40 percent of the voting stock of foreign corporation B on January 1, 1991, and continues to own that stock until June 1, 1991, when Corporation A sells its stock in Corporation B. Both Corporation A and Corporation B use the calendar year as the taxable year. Corporation B pays a dividend out of its post-1986 undistributed earnings to Corporation A, which Corporation A receives on February 16, 1991. Corporation A pays a dividend out of its post-1986 undistributed earnings to Corporation M, which Corporation M receives on January 20, 1992. Corporation M uses a fiscal year ending on June 30 as the taxable year.

(ii) On February 16, 1991, when Corporation B pays a dividend to Corporation A, Corporation M satisfies the 10 percent stock ownership requirement of paragraphs (a) (1) and (2) of this section with respect to Corporation A. Therefore, Corporation A is a first-tier corporation within the meaning of paragraph (a)(2) of this section and Corporation M is a domestic shareholder of Corporation A within the meaning of paragraph (a)(1) of this section. Also on February 16, 1991, Corporation B is a second-tier corporation within the meaning of paragraph (a)(3) of this section because Corporation A owns at least 10 percent of its voting stock, and the percentage of voting stock owned by Corporation M in Corporation A on February 16, 1991 (30 percent) multiplied by the percentage of voting stock owned by Corporation A in Corporation B on February 16, 1991 (40 percent) equals 12 percent. Corporation A shall be deemed to have paid foreign income taxes of Corporation B with respect to the dividend received from Corporation B on February 16, 1991.

(iii) On January 20, 1992, Corporation M satisfies the 10-percent stock ownership requirement of paragraphs (a)(1) and (2) of this section with respect to Corporation A. Therefore, Corporation A is a first-tier corporation within the meaning of paragraph (a)(2) of this section and Corporation M is a domestic shareholder within the meaning of paragraph (a)(1) of this section. Accordingly, for its taxable year ending on June 30, 1992, Corporation M is deemed to have paid a portion of the post-1986 foreign income taxes paid, accrued, or deemed to be paid, by Corporation A. Those taxes will include taxes paid by Corporation B that were deemed paid by Corporation A with respect to the dividend paid by Corporation B to Corporation A on February 16, 1991, even though Corporation B is no longer a second-tier corporation with respect to Corporations A and M on January 20, 1992, and has not been a second-tier corporation with respect to Corporations A and M at any time during the taxable years of Corporations A and M that include January 20, 1992.

(6) *Upper- and lower-tier corporations.* In the case of a sixth-tier corporation, the term *upper-tier corporation* means a first-, second-, third-, fourth-, or fifth-tier corporation. In the case of a fifth-tier corporation, the term upper-tier corporation means a first-, second-, third-, or fourth-tier corporation. In the case of a fourth-tier corporation, the term upper-tier corporation means a first-, second-, or third-tier corporation. In the case of a third-tier corporation, the term upper-tier corporation means a first- or second-tier corporation. In the case of a second-tier corporation, the term upper-tier corporation means a first-tier corporation. In the case of a first-tier corporation, the

term *lower-tier corporation* means a second-, third-, fourth-, fifth-, or sixth-tier corporation. In the case of a second-tier corporation, the term lower-tier corporation means a third-, fourth-, fifth-, or sixth-tier corporation. In the case of a third-tier corporation, the term lower-tier corporation means a fourth-, fifth-, or sixth-tier corporation. In the case of a fourth-tier corporation, the term lower-tier corporation means a fifth- or sixth-tier corporation. In the case of a fifth-tier corporation, the term lower-tier corporation means a sixth-tier corporation.

(7) *Foreign income taxes*. The term *foreign income taxes* means income, war profits, and excess profits taxes as defined in §1.901–2(a), and taxes included in the term income, war profits, and excess profits taxes by reason of section 903, that are imposed by a foreign country or a possession of the United States, including any such taxes deemed paid by a foreign corporation under this section. Foreign income, war profits, and excess profits taxes shall not include amounts excluded from the definition of those taxes pursuant to section 901 and the regulations under that section. *See* section 901(f) and (i) and paragraph (c)(5) of this section. Foreign income, war profits, and excess profits taxes also shall not include taxes for which a credit is disallowed under section 901 and the regulations under section 901. *See* section 901(j), (k), and (l), and paragraphs (c)(4) and (8) of this section.

(8) *Post-1986 foreign income taxes*—(i) *In general*. Except as provided in paragraphs (a)(10) and (13) of this section, the term *post-1986 foreign income taxes* of a foreign corporation means the sum of the foreign income taxes paid, accrued, or deemed paid in the taxable year of the foreign corporation in which it distributes a dividend plus the foreign income taxes paid, accrued, or deemed paid in the foreign corporation's prior taxable years beginning after December 31, 1986, to the extent the foreign taxes were not attributable to dividends distributed to, or earnings otherwise included (for example, under section 304, 367(b), 551, 951(a), 1248, or 1293) in the income of, a foreign or domestic shareholder in prior taxable years. Except as provided in paragraph (b)(4) of this section, foreign taxes paid or deemed paid by the foreign corporation on or with respect to earnings that were distributed or otherwise removed from post-1986 undistributed earnings in prior post-1986 taxable years shall be removed from post-1986 foreign income taxes regardless of whether the shareholder is eligible to compute an amount of foreign taxes deemed paid under section 902, and regardless of whether the shareholder in fact chose to credit foreign income taxes under section 901 for the year of the distribution or inclusion. Thus, if an amount is distributed or deemed distributed by a foreign corporation to a United States person that is not a domestic shareholder within the meaning of paragraph (a)(1) of this section (for example, an individual or a corporation that owns less than 10% of the foreign corporation's voting stock), or to a foreign person that does not meet the definition of an upper-tier corporation under paragraph (a)(6) of this section, then although no foreign income taxes shall be deemed paid under section 902, foreign income taxes attributable to the distribution or deemed distribution that would have been deemed paid had the shareholder met the ownership requirements of paragraphs (a)(1) through (4) of this section shall be removed from post-1986 foreign income taxes. Further, if a domestic shareholder chooses to deduct foreign taxes paid or accrued for the taxable year of the distribution or inclusion, it shall nonetheless be deemed to have paid a proportionate share of the foreign corporation's post-1986 foreign income taxes under section 902(a), and the foreign income taxes deemed paid must be removed from post-1986 foreign income taxes. In the case of a foreign corporation the foreign income taxes of which are determined based on an accounting period of less than one year, the term *year* means that accounting period. *See* sections 441(b)(3) and 443.

(ii) *Distributions out of earnings and profits accumulated by a lower-tier corporation in its taxable years beginning before January 1, 1987, and included in the gross income of an upper-tier corporation in its taxable year beginning after December 31, 1986*. Post-1986 foreign income taxes shall include foreign income

taxes that are deemed paid by an upper-tier corporation with respect to distributions from a lower-tier corporation out of nonpreviously taxed pre-1987 accumulated profits, as defined in paragraph (a)(10) of this section, that are received by an upper-tier corporation in any taxable year of the upper-tier corporation beginning after December 31, 1986, provided the upper-tier corporation's earnings and profits in that year are included in its post-1986 undistributed earnings under paragraph (a)(9) of this section. Foreign income taxes deemed paid with respect to a distribution of pre-1987 accumulated profits shall be translated from the functional currency of the lower-tier corporation into dollars at the spot exchange rate in effect on the date of the distribution. To determine the character of the earnings and profits and associated taxes for foreign tax credit limitation purposes, see section 904 and §1.904–7(a).

(iii) *Foreign income taxes paid or accrued with respect to high withholding tax interest.* Post-1986 foreign income taxes shall not include foreign income taxes paid or accrued by a noncontrolled section 902 corporation (as defined in section 904(d)(2)(E)(i)) in a taxable year beginning on or before December 31, 2002 with respect to high withholding tax interest (as defined in section 904(d)(2)(B)) to the extent the foreign tax rate imposed on such interest exceeds 5 percent. See section 904(d)(2)(E)(ii) and §1.904–4(g)(2)(iii) (26 CFR revised as of April 1, 2006). The reduction in foreign income taxes paid or accrued by the amount of tax in excess of 5 percent imposed on high withholding tax interest income must be computed in functional currency before foreign income taxes are translated into U.S. dollars and included in post-1986 foreign income taxes.

(9) *Post-1986 undistributed earnings*—(i) *In general.* Except as provided in paragraphs (a) (10) and (13) of this section, the term post-1986 undistributed earnings means the amount of the earnings and profits of a foreign corporation (computed in accordance with sections 964(a) and 986) accumulated in taxable years of the foreign corporation beginning after December 31, 1986, determined as of the close of the taxable year of the foreign corporation in which it distributes a dividend. Post-1986 undistributed earnings shall not be reduced by reason of any earnings distributed or otherwise included in income, for example under section 304, 367(b), 551, 951(a), 1248 or 1293, during the taxable year. Post-1986 undistributed earnings shall be reduced to account for distributions or deemed distributions that reduced earnings and profits and inclusions that resulted in previously-taxed amounts described in section 959(c) (1) and (2) or section 1293(c) in prior taxable years beginning after December 31, 1986. Thus, post-1986 undistributed earnings shall not be reduced to the extent of the ratable share of a controlled foreign corporation's subpart F income, as defined in section 952, attributable to a shareholder that is not a United States shareholder within the meaning of section 951(b) or section 953(c)(1)(A), because that amount has not been included in a shareholder's gross income. Post-1986 undistributed earnings shall be reduced as provided herein regardless of whether any shareholder is deemed to have paid any foreign taxes, and regardless of whether any domestic shareholder chose to claim a foreign tax credit under section 901(a) for the year of the distribution. For rules on carrybacks and carryforwards of deficits and their effect on post-1986 undistributed earnings, see §1.902–2. In the case of a foreign corporation the foreign income taxes of which are computed based on an accounting period of less than one year, the term year means that accounting period. See sections 441(b)(3) and 443.

(ii) *Distributions out of earnings and profits accumulated by a lower-tier corporation in its taxable years beginning before January 1, 1987, and included in the gross income of an upper-tier corporation in its taxable year beginning after December 31, 1986.* Distributions by a lower-tier corporation out of non-previously taxed pre-1987 accumulated profits, as defined in paragraph (a)(10) of this section, that are received by an upper-tier corporation in any taxable year of the upper-tier corporation beginning after December 31, 1986, shall be treated as post-1986 undistributed earnings of the upper-tier corporation, provided the

upper-tier corporation's earnings and profits for that year are included in its post-1986 undistributed earnings under paragraph (a)(9)(i) of this section. To determine the character of the earnings and profits and associated taxes for foreign tax credit limitation purposes, see section 904 and § 1.904–7(a).

(iii) *Reduction for foreign income taxes paid or accrued.* In computing post-1986 undistributed earnings, earnings and profits shall be reduced by foreign income taxes paid or accrued regardless of whether the taxes are creditable. Thus, earnings and profits shall be reduced by foreign income taxes paid with respect to high withholding tax interest even though a portion of the taxes is not creditable pursuant to section 904(d)(2)(E)(ii) and is not included in post-1986 foreign income taxes under paragraph (a)(8)(iii) of this section. Earnings and profits of an upper-tier corporation, however, shall not be reduced by foreign income taxes paid by a lower-tier corporation and deemed to have been paid by the upper-tier corporation.

(iv) *Special allocations.* The term post-1986 undistributed earnings means the total amount of the earnings of the corporation determined at the corporate level. Special allocations of earnings and taxes to particular shareholders, whether required or permitted by foreign law or a shareholder agreement, shall be disregarded. If, however, the Commissioner establishes that there is an agreement to pay dividends only out of earnings in the separate categories for passive or high withholding tax interest income, then only taxes imposed on passive or high withholding tax interest earnings shall be treated as related to the dividend. See § 1.904–6(a)(2).

(10) *Pre-1987 accumulated profits*—(i) *Definition.* The term pre-1987 accumulated profits means the amount of the earnings and profits of a foreign corporation computed in accordance with section 902 and attributable to its taxable years beginning before January 1, 1987. If the special effective date of paragraph (a)(13) of this section applies, pre-1987 accumulated profits also includes any earnings and profits (computed in accordance with sections 964(a) and 986) attributable to the foreign corporation's taxable years beginning after December 31, 1986, but before the first day of the first taxable year of the foreign corporation in which the ownership requirements of section 902(c)(3)(B) and paragraphs (a) (1) through (4) of this section are met with respect to that corporation.

(ii) *Computation of pre-1987 accumulated profits.* Pre-1987 accumulated profits must be computed under United States principles governing the computation of earnings and profits. Pre-1987 accumulated profits are determined at the corporate level. Special allocations of accumulated profits and taxes to particular shareholders with respect to distributions of pre-1987 accumulated profits in taxable years beginning after December 31, 1986, whether required or permitted by foreign law or a shareholder agreement, shall be disregarded. Pre-1987 accumulated profits of a particular year shall be reduced by amounts distributed from those accumulated profits or otherwise included in income from those accumulated profits, for example under sections 304, 367(b), 551, 951(a), 1248 or 1293. If a deficit in post-1986 undistributed earnings is carried back to offset pre-1987 accumulated profits, pre-1987 accumulated profits of a particular taxable year shall be reduced by the amount of the deficit carried back to that year. See § 1.902–2. The amount of a distribution out of pre-1987 accumulated profits, and the amount of foreign income taxes deemed paid under section 902, shall be determined and translated into United States dollars by applying the law as in effect prior to the effective date of the Tax Reform Act of 1986. See §§ 1.902–3, 1.902–4 and 1.964–1.

(iii) *Foreign income taxes attributable to pre-1987 accumulated profits.* The term pre-1987 foreign income taxes means any foreign income taxes paid, accrued, or deemed paid by a foreign corporation on or with respect to its pre-1987 accumulated profits. Pre-1987 foreign income taxes of a particular year shall be reduced by the amount of taxes paid or deemed paid by the foreign corporation on or with respect to amounts distributed or otherwise included in income from pre-1987 accumulated profits of that year. Thus, pre-1987 foreign income taxes shall be reduced by the

amount of taxes deemed paid by a domestic shareholder (regardless of whether the shareholder chose to credit foreign income taxes under section 901 for the year of the distribution or inclusion) or a first-tier or second-tier corporation, and by the amount of taxes that would have been deemed paid had any other shareholder been eligible to compute an amount of foreign taxes deemed paid under section 902. Foreign income taxes deemed paid with respect to a distribution of pre-1987 accumulated profits shall be translated from the functional currency of the distributing corporation into United States dollars at the spot exchange rate in effect on the date of the distribution.

(11) *Dividend*. For purposes of section 902, the definition of the term dividend in section 316 and the regulations under that section applies. Thus, for example, distributions and deemed distributions under sections 302, 304, 305(b) and 367(b) that are treated as dividends within the meaning of section 301(c)(1) also are dividends for purposes of section 902. In addition, the term dividend includes deemed dividends under sections 551 and 1248, but not deemed inclusions under sections 951(a) and 1293. For rules concerning excess distributions from section 1291 funds that are treated as dividends solely for foreign tax credit purposes, (see Regulation Project INTL–656–87 published in 1992–1 C.B. 1124; see § 601.601(d)(2)(ii)(*b*) of this chapter).

(12) *Dividend received*. A dividend shall be considered received for purposes of section 902 when the cash or other property is unqualifiedly made subject to the demands of the distributee. See § 1.301–1(b). A dividend also is considered received for purposes of section 902 when it is deemed received under section 304, 367(b), 551, or 1248.

(13) *Special effective date*—(i) *Rule*. If the first day on which the ownership requirements of section 902(c)(3)(B) and paragraphs (a)(1) through (4) of this section are met with respect to a foreign corporation, without regard to whether a dividend is distributed, is in a taxable year of the foreign corporation beginning after December 31, 1986, then—

(A) The post-1986 undistributed earnings and post-1986 foreign income taxes of the foreign corporation shall be determined by taking into account only taxable years beginning on and after the first day of the first taxable year of the foreign corporation in which the ownership requirements are met, including subsequent taxable years in which the ownership requirements of section 902(c)(3)(B) and paragraphs (a)(1) through (4) of this section are not met; and

(B) Earnings and profits accumulated prior to the first day of the first taxable year of the foreign corporation in which the ownership requirements of section 902(c)(3)(B) and paragraphs (a)(1) through (4) of this section are met shall be considered pre-1987 accumulated profits.

(ii) *Example*. The following example illustrates the special effective date rules of this paragraph (a)(13):

Example. As of December 31, 1991, and since its incorporation, foreign corporation A has owned 100 percent of the stock of foreign corporation B. Corporation B is not a controlled foreign corporation. Corporation B uses the calendar year as its taxable year, and its functional currency is the u. Assume 1u equals $1 at all relevant times. On April 1, 1992, Corporation B pays a 200u dividend to Corporation A and the ownership requirements of section 902(c)(3)(B) and paragraphs (a)(1) through (4) of this section are not met at that time. On July 1, 1992, domestic corporation M purchases 10 percent of the Corporation B stock from Corporation A and, for the first time, Corporation B meets the ownership requirements of section 902(c)(3)(B) and paragraph (a)(2) of this section. Corporation M uses the calendar year as its taxable year. Corporation B does not distribute any dividends to Corporation M during 1992. For its taxable year ending December 31, 1992, Corporation B has 500u of earnings and profits (after foreign taxes but before taking into account the 200u distribution to Corporation A) and pays 100u of foreign income taxes that is equal to $100. Pursuant to paragraph (a)(13)(i) of this section, Corporation B's post-1986 undistributed earnings and post-1986 foreign income taxes will include earnings and profits and foreign income taxes attributable to Corporation B's entire 1992 taxable year and all taxable years thereafter. Thus, the April 1, 1992, dividend to Corporation A will reduce post-1986 undistributed earnings to 300u (500u–200u) under paragraph (a)(9)(i) of this section. The foreign income taxes attributable to the amount distributed as a dividend to Corporation A will not be

creditable because Corporation A is not a domestic shareholder. Post-1986 foreign income taxes, however, will be reduced by the amount of foreign taxes attributable to the dividend. Thus, as of the beginning of 1993, Corporation B has $60 ($100–[$100 × 40% (200u/500u)]) of post-1986 foreign income taxes. See paragraphs (a)(8)(i) and (b)(1) of this section.

(b) *Computation of foreign income taxes deemed paid by a domestic shareholder, first-tier corporation, or lower-tier corporation*—(1) *General rule.* If a foreign corporation pays a dividend in any taxable year out of post-1986 undistributed earnings to a shareholder that is a domestic shareholder or an upper-tier corporation at the time it receives the dividend, the recipient shall be deemed to have paid the same proportion of any post-1986 foreign income taxes paid, accrued or deemed paid by the distributing corporation on or with respect to post-1986 undistributed earnings which the amount of the dividend out of post-1986 undistributed earnings (determined without regard to the gross-up under section 78) bears to the amount of the distributing corporation's post-1986 undistributed earnings. An upper-tier corporation shall not be entitled to compute an amount of foreign taxes deemed paid on a dividend from a lower-tier corporation, however, unless the ownership requirements of paragraphs (a) (1) through (4) of this section are met at each tier at the time the upper-tier corporation receives the dividend. Foreign income taxes deemed paid by a domestic shareholder or an upper-tier corporation must be computed under the following formula:

$$\text{Foreign income taxes deemed paid by domestic shareholder (or upper-tier corporation)} = \text{Post-1986 foreign income taxes of first-tier corporation (or lower-tier corporation)} \times \frac{\text{Dividend paid to domestic shareholder (or upper-tier corporation) by first-tier corporation (or lower-tier corporation)}}{\text{Post-1986 undistributed earnings of first-tier corporation (or lower-tier corporation)}}$$

(2) *Allocation rule for dividends attributable to post-1986 undistributed earnings and pre-1987 accumulated profits*—(i) *Portion of dividend out of post-1986 undistributed earnings.* Dividends will be deemed to be paid first out of post-1986 undistributed earnings to the extent thereof. If dividends exceed post-1986 undistributed earnings and dividends are paid to more than one shareholder, then the dividend to each shareholder shall be deemed to be paid pro rata out of post-1986 undistributed earnings, computed as follows:

$$\text{Portion of Dividend to a Shareholder Attributable to Post-1986 Undistributed Earnings} = \text{Post-1986 Undistributed Earnings} \times \frac{\text{Dividends to Shareholder}}{\text{Total Dividends Paid To all Shareholders}}$$

(ii) *Portion of dividend out of pre-1987 accumulated profits.* After the portion of the dividend attributable to post-1986 undistributed earnings is determined under paragraph (b)(2)(i) of this section, the remainder of the dividend received by a shareholder is attributable to pre-1987 accumulated profits to the extent thereof. That part of the dividend attributable to pre-1987 accumulated profits will be treated as paid first from the most recently accumulated earnings and profits. See § 1.902–3. If dividends paid out of pre-1987 accumulated profits are attributable to more than one pre-1987 taxable year

and are paid to more than one shareholder, then the dividend to each shareholder attributable to earnings and profits accumulated in a particular pre-1987 taxable year shall be deemed to be paid pro rata out of accumulated profits of that taxable year, computed as follows:

$$\text{Portion of Dividend to a Shareholder Attributable to Accumulated Profits of a Particular Pre-1987 Taxable Year} = \text{Dividend Paid Out of Pre-1987 Accumulated Profits with Respect to the Particular Pre-1987 Taxable Year} \times \frac{\text{Dividends to Shareholder}}{\text{Total Dividends Paid To all Shareholders}}$$

(3) *Dividends paid out of pre-1987 accumulated profits.* If dividends are paid by a first-tier corporation or a lower-tier corporation out of pre-1987 accumulated profits, the domestic shareholder or upper-tier corporation that receives the dividends shall be deemed to have paid foreign income taxes to the extent provided under section 902 and the regulations thereunder as in effect prior to the effective date of the Tax Reform Act of 1986. See paragraphs (a) (10) and (13) of this section and §§ 1.902–3 and 1.902–4.

(4) *Deficits in accumulated earnings and profits.* No foreign income taxes shall be deemed paid with respect to a distribution from a foreign corporation out of current earnings and profits that is treated as a dividend under section 316(a)(2), and post-1986 foreign income taxes shall not be reduced, if as of the end of the taxable year in which the dividend is paid or accrued, the corporation has zero or a deficit in post-1986 undistributed earnings and the sum of current plus accumulated earnings and profits is zero or less than zero. The dividend shall reduce post-1986 undistributed earnings and accumulated earnings and profits.

(5) *Examples.* The following examples illustrate the rules of this paragraph (b):

Example 1. Domestic corporation M owns 100 percent of foreign corporation A. Both Corporation M and Corporation A use the calendar year as the taxable year, and Corporation A uses the u as its functional currency. Assume that 1u equals $1 at all relevant times. All of Corporation A's pre-1987 accumulated profits and post-1986 undistributed earnings are non-subpart F general limitation earnings and profits under section 904(d)(1)(I). As of December 31, 1992, Corporation A has 100u of post-1986 undistributed earnings and $40 of post-1986 foreign income taxes. For its 1986 taxable year, Corporation A has accumulated profits of 200u (net of foreign taxes) and paid 60u of foreign income taxes on those earnings. In 1992, Corporation A distributes 150u to Corporation M. Corporation A has 100u of post-1986 undistributed earnings and the dividend, therefore, is treated as paid out of post-1986 undistributed earnings to the extent of 100u. The first 100u distribution is from post-1986 undistributed earnings, and, because the distribution exhausts those earnings, Corporation M is deemed to have paid the entire amount of post-1986 foreign income taxes of Corporation A ($40). The remaining 50u dividend is treated as a dividend out of 1986 accumulated profits under paragraph (b)(2) of this section. Corporation M is deemed to have paid $15 (60u × 50u/200u, translated at the appropriate exchange rates) of Corporation A's foreign income taxes for 1986. As of January 1, 1993, Corporation A's post-1986 undistributed earnings and post-1986 foreign income taxes are 0. Corporation A has 150u of accumulated profits and 45u of foreign income taxes remaining in 1986.

Example 2. Domestic corporation M (incorporated on January 1, 1987) owns 100 percent of foreign corporation A (incorporated on January 1, 1987). Both Corporation M and Corporation A use the calendar year as the taxable year, and Corporation A uses the u as its functional currency. Assume that 1u equals $1 at all relevant times. Corporation A has no pre-1987 accumulated profits. All of Corporation A's post-1986 undistributed earnings are non-subpart F general limitation earnings and profits under section 904(d)(1)(I). On January 1, 1992, Corporation A has a deficit in accumulated earnings and profits and a deficit in post-1986 undistributed earnings of (200u). No foreign taxes have been paid with respect to post-1986 undistributed earnings. During 1992, Corporation A earns 100u (net of foreign taxes), pays $40 of foreign taxes on those earnings and distributes 50u to Corporation M. As of the end of 1992, Corporation A has a deficit of (100u)

((200u) post1986 undistributed earnings + 100u current earnings and profits) in post-1986 undistributed earnings. Corporation A, however, has current earnings and profits of 100u. Therefore, the 50u distribution is treated as a dividend in its entirety under section 316(a)(2). Under paragraph (b)(4) of this section, Corporation M is not deemed to have paid any of the foreign taxes paid by Corporation A because post-1986 undistributed earnings and the sum of current plus accumulated earnings and profits are (100u). The dividend reduces both post-1986 undistributed earnings and accumulated earnings and profits. Therefore, as of January 1, 1993, Corporation A's post-1986 undistributed earnings are (150u) and its accumulated earnings and profits are (150u). Corporation A's post-1986 foreign income taxes at the start of 1993 are $40.

(c) *Special rules*—(1) *Separate computations required for dividends from each first-tier and lower-tier corporation*—(i) *Rule*. If in a taxable year dividends are received by a domestic shareholder or an upper-tier corporation from two or more first-tier corporations or two or more lower-tier corporations, the foreign income taxes deemed paid by the domestic shareholder or the upper-tier corporation under sections 902 (a) and (b) and paragraph (b) of this section shall be computed separately with respect to the dividends received from each first-tier corporation or lower-tier corporation. If a domestic shareholder receives dividend distributions from one or more first-tier corporations and in the same taxable year the first-tier corporation receives dividends from one or more lower-tier corporations, then the amount of foreign income taxes deemed paid shall be computed by starting with the lowest-tier corporation and working upward.

(ii) *Example*. The following example illustrates the application of this paragraph (c)(1):

Example. P, a domestic corporation, owns 40 percent of the voting stock of foreign corporation S. S owns 30 percent of the voting stock of foreign corporation T, and 30 percent of the voting stock of foreign corporation U. Neither S, T, nor U is a controlled foreign corporation. P, S, T and U all use the calendar year as their taxable year. In 1993, T and U both pay dividends to S and S pays a dividend to P. To compute foreign taxes deemed paid, paragraph (c)(1) of this section requires P to start with the lowest tier corporations and to compute foreign taxes deemed paid separately for dividends from each first-tier and lower-tier corporation. Thus, S first will compute foreign taxes deemed paid separately on its dividends from T and U. The deemed paid taxes will be added to S's post-1986 foreign income taxes, and the dividends will be added to S's post-1986 undistributed earnings. Next, P will compute foreign taxes deemed paid with respect to the dividend from S. This computation will take into account the taxes paid by T and U and deemed paid by S.

(2) *Section 78 gross-up*—(i) *Foreign income taxes deemed paid by a domestic shareholder*. Except as provided in section 960(b) and the regulations under that section (relating to amounts excluded from gross income under section 959(b)), any foreign income taxes deemed paid by a domestic shareholder in any taxable year under section 902(a) and paragraph (b) of this section shall be included in the gross income of the domestic shareholder for the year as a dividend under section 78. Amounts included in gross income under section 78 shall, for purposes of section 904, be deemed to be derived from sources within the United States to the extent the earnings and profits on which the taxes were paid are treated under section 904(g) as United States source earnings and profits. Section 1.904–5(m)(6). Amounts included in gross income under section 78 shall be treated for purposes of section 904 as income in a separate category to the extent that the foreign income taxes were allocated and apportioned to income in that separate category. See section 904(d)(3)(G) and § 1.904–6(b)(3).

(ii) *Foreign income taxes deemed paid by an upper-tier corporation*. Foreign income taxes deemed paid by an upper-tier corporation on a distribution from a lower-tier corporation are not included in the earnings and profits of the upper-tier corporation. For purposes of section 904, foreign income taxes shall be allocated and apportioned to income in a separate category to the extent those taxes were allocated to the earnings and profits of the lower-tier corporation in that separate category. See section 904(d)(3)(G) and § 1.904–6(b)(3). To the extent that section 904(g) treats the earnings of the lower-tier corporation on which those foreign income taxes were paid as United States source earnings and profits, the foreign income taxes deemed paid by the upper-tier corporation on

the distribution from the lower-tier corporation shall be treated as attributable to United States source earnings and profits. See section 904(g) and § 1.904–5(m)(6).

(iii) *Example*. The following example illustrates the rules of this paragraph (c)(2):

Example. P, a domestic corporation, owns 100 percent of the voting stock of controlled foreign corporation S. Corporations P and S use the calendar year as their taxable year, and S uses the u as its functional currency. Assume that 1u equals $1 at all relevant times. As of January 1, 1992, S has –0– post-1986 undistributed earnings and –0– post-1986 foreign income taxes. In 1992, S earns 150u of non-subpart F general limitation income net of foreign taxes and pays 60u of foreign income taxes. As of the end of 1992, but before dividend payments, S has 150u of post-1986 undistributed earnings and $60 of post-1986 foreign income taxes. Assume that 50u of S's earnings for 1992 are from United States sources. S pays P a dividend of 75u which P receives in 1992. Under § 1.904–5(m)(4), one-third of the dividend, or 25u (75u × 50u/150u), is United States source income to P. P computes foreign taxes deemed paid on the dividend under paragraph (b)(1) of this section of $30 ($60 × 50%[75u/150u]) and includes that amount in gross income under section 78 as a dividend. Because 25u of the 75u dividend is United States source income to P, $10 ($30 × 33.33%[25u/75u]) of the section 78 dividend will be treated as United States source income to P under this paragraph (c)(2).

(3) *Creditable foreign income taxes*. The amount of creditable foreign income taxes under section 901 shall include, subject to the limitations and conditions of sections 902 and 904, foreign income taxes actually paid and deemed paid by a domestic shareholder that receives a dividend from a first-tier corporation. Foreign income taxes deemed paid by a domestic shareholder under paragraph (b) of this section shall be deemed paid by the domestic shareholder only for purposes of computing the foreign tax credit allowed under section 901.

(4) *Foreign mineral income*. Certain foreign income, war profits and excess profits taxes paid or accrued with respect to foreign mineral income will not be considered foreign income taxes for purposes of section 902. See section 901(e) and § 1.901–3.

(5) *Foreign taxes paid or accrued in connection with the purchase or sale of certain oil and gas*. Certain income, war profits, or excess profits taxes paid or accrued to a foreign country in connection with the purchase and sale of oil or gas extracted in that country will not be considered foreign income taxes for purposes of section 902. See section 901(f).

(6) *Foreign oil and gas extraction income*. For rules relating to reduction of the amount of foreign income taxes deemed paid with respect to foreign oil and gas extraction income, see section 907(a) and the regulations under that section.

(7) *United States shareholders of controlled foreign corporations*. See paragraph (d) of this section and sections 960 and 962 and the regulations under those sections for special rules relating to the application of section 902 in computing foreign income taxes deemed paid by United States shareholders of controlled foreign corporations.

(8) *Effect of certain liquidations, reorganizations, or similar transactions on certain foreign taxes paid or accrued in taxable years beginning on or before August 5, 1997*—(i) *General rule*. Notwithstanding the effect of any liquidation, reorganization, or similar transaction, foreign taxes paid or accrued by a member of a qualified group (as defined in section 902(b)(2)) shall not be eligible to be deemed paid if they were paid or accrued in a taxable year beginning on or before August 5, 1997, by a corporation that was a fourth-, fifth- or sixth-tier corporation with respect to the taxpayer on the first day of the corporation's first taxable year beginning after August 5, 1997.

(ii) *Example*. The following examples illustrate the application of this paragraph (c)(8):

Example. P, a domestic corporation, has owned 100 percent of the voting stock of foreign corporation S at all times since January 1, 1987. Until June 30, 2002, S owned 100 percent of the voting stock of foreign corporation T, T owned 100 percent of the voting stock of foreign corporation U, and U owned 100 percent of the voting stock of foreign corporation V. P, S, T, U, and V each use the calendar year as their U.S. taxable year. Thus, beginning in 1998 V was a fourth-tier controlled foreign corporation, and its foreign taxes paid or accrued in 1998 and later taxable years were eligible to be deemed

paid. On June 30, 2002, T was liquidated, causing S to acquire 100 percent of the stock of U. As a result, V became a third-tier controlled foreign corporation. In 2003, V paid a dividend to U. Under paragraph (c)(8) of this section, foreign taxes paid by V in taxable years beginning before 1998 are not taken into account in computing the foreign taxes deemed paid with respect to the dividend paid by V to U.

(d) *Dividends from controlled foreign corporations and noncontrolled section 902 corporations*—(1) *General rule*. If a dividend is described in paragraphs (d)(1)(i) through (iv) of this section, the following rules apply. If a dividend is paid out of post-1986 undistributed earnings or pre-1987 accumulated profits of a foreign corporation attributable to more than one separate category, the amount of foreign income taxes deemed paid by the domestic shareholder or the upper-tier corporation under section 902 and paragraph (b) of this section shall be computed separately with respect to the post-1986 undistributed earnings or pre-1987 accumulated profits in each separate category out of which the dividend is paid. *See* §1.904–5(c)(4) and (i), and paragraph (d)(2) of this section. The separately computed deemed-paid taxes shall be added to other taxes paid by the domestic shareholder or upper-tier corporation with respect to income in the appropriate separate category. The rules of this paragraph (d)(1) apply to dividends received by —

(i) A domestic shareholder that is a United States shareholder (as defined in section 951(b) or section 953(c)) from a first-tier corporation that is a controlled foreign corporation;

(ii) A domestic shareholder from a first-tier corporation that is a noncontrolled section 902 corporation;

(iii) An upper-tier controlled foreign corporation from a lower-tier controlled foreign corporation if the corporations are related look-through entities within the meaning of §1.904–5(i) (*see* §1.904–5(i)(3)); or

(iv) A foreign corporation that is eligible to compute an amount of foreign taxes deemed paid under section 902(b)(1), from a controlled foreign corporation or a noncontrolled section 902 corporation (that is, both the payor and payee corporations are members of the same qualified group as defined in section 902(b)(2) (*see* §1.904–5 (i)(4)).

(2) *Look-through*—(i) *Dividends*. Any dividend distribution by a controlled foreign corporation or noncontrolled section 902 corporation to a domestic shareholder or a foreign corporation that is eligible to compute an amount of foreign taxes deemed paid under section 902(b)(1) shall be deemed paid pro rata out of each separate category of income. Any dividend distribution by a controlled foreign corporation to a controlled foreign corporation that is a related look-through entity within the meaning of §1.904–5(i)(3) shall also be deemed to be paid pro rata out of each separate category of income. *See* §§1.904–5(c)(4) and (i), and 1.904–7. The portion of the foreign income taxes attributable to a particular separate category that shall be deemed paid by the domestic shareholder or upper-tier corporation must be computed under the following formula:

$$\text{Foreign taxes deemed paid by domestic shareholder or upper-tier corporation with respect to a separate category} = \text{Post-1986 foreign income taxes of first-tier or lower-tier corporation allocated and apportioned to the separate category under §1.904-6} \times \frac{\text{Dividend amount attributable to the separate category}}{\text{Post-1986 undistributed earnings of first-tier or lower-tier corporation in the separate category}}$$

(ii) *Coordination with section 960*. For rules coordinating the computation of foreign taxes deemed paid with respect to amounts included in gross income under section 951(a) and dividends distributed by a controlled foreign corporation, see section 960 and the regulations under that section.

(e) *Information to be furnished*. If the credit for foreign income taxes claimed under section 901 includes foreign income taxes deemed paid under section 902 and paragraph (b) of this section, the domestic shareholder must furnish the same information with respect to the foreign income taxes deemed paid as it is required to furnish with respect

to the foreign income taxes it directly paid or accrued and for which the credit is claimed. See § 1.905–2. For other information required to be furnished by the domestic shareholder for the annual accounting period of certain foreign corporations ending with or within the shareholder's taxable year, and for reduction in the amount of foreign income taxes paid, accrued, or deemed paid for failure to furnish the required information, see section 6038 and the regulations under that section.

(f) *Examples*. The following examples illustrate the application of this section:

Example 1. Since 1987, domestic corporation M has owned 10 percent of the one class of stock of foreign corporation A. The remaining 90 percent of Corporation A's stock is owned by Z, a foreign corporation. Corporation A is not a controlled foreign corporation. Corporation A uses the u as its functional currency, and 1u equals $1 at all relevant times. Both Corporation A and Corporation M use the calendar year as the taxable year. In 1992, Corporation A pays a 30u dividend out of post-1986 undistributed earnings, 3u to Corporation M and 27u to Corporation Z. Corporation M is deemed, under paragraph (b) of this section, to have paid a portion of the post-1986 foreign income taxes paid by Corporation A and includes the amount of foreign taxes deemed paid in gross income under section 78 as a dividend. Both the foreign taxes deemed paid and the dividend would be subject to a separate limitation for dividends from Corporation A, a noncontrolled section 902 corporation. Under paragraph (a)(9)(i) of this section, Corporation A must reduce its post-1986 undistributed earnings as of January 1, 1993, by the total amount of dividends paid to Corporation M and Corporation Z in 1992. Under paragraph (a)(8)(i) of this section, Corporation A must reduce its post-1986 foreign income taxes as of January 1, 1993, by the amount of foreign income taxes that were deemed paid by Corporation M and by the amount of foreign income taxes that would have been deemed paid by Corporation Z had Corporation Z been eligible to compute an amount of foreign income taxes deemed paid with respect to the dividend received from Corporation A. Foreign income taxes deemed paid by Corporation M and Corporation A's opening balances in post-1986 undistributed earnings and post-1986 foreign income taxes for 1993 are computed as follows:

1. Assumed post-1986 undistributed earnings of Corporation A at start of 1992	25u
2. Assumed post-1986 foreign income taxes of Corporation A at start of 1992	$25
3. Assumed pre-tax earnings and profits of Corporation A for 1992	50u
4. Assumed foreign income taxes paid or accrued by Corporation A in 1992	15u
5. Post-1986 undistributed earnings in Corporation A for 1992 (pre-dividend) (Line 1 plus Line 3 minus Line 4)	60u
6. Post-1986 foreign income taxes in Corporation A for 1992 (pre-dividend) (Line 2 plus Line 4 translated at the appropriate exchange rates).	$40
7. Dividends paid out of post-1986 undistributed earnings of Corporation A to Corporation M in 1992	3u
8. Percentage of Corporation A's post-1986 undistributed earnings paid to Corporation M (Line 7 divided by Line 5).	5%
9. Foreign income taxes of Corporation A deemed paid by Corporation M under section 902(a) (Line 6 multiplied by Line 8).	$2
10. Total dividends paid out of post-1986 undistributed earnings of Corporation A to all shareholders in 1992	30u
11. Percentage of Corporation A's post-1986 undistributed earnings paid to all shareholders in 1992 (Line 10 divided by Line 5).	50%
12. Post-1986 foreign income taxes paid with respect to post-1986 undistributed earnings distributed to all shareholders in 1992 (Line 6 multiplied by Line 11).	$20
13. Corporation A's post-1986 undistributed earnings at the start of 1993 (Line 5 minus Line 10)	30u
14. Corporation A's post-1986 foreign income taxes at the start of 1993 (Line 6 minus Line 12)	$20

Example 2. (i) The facts are the same as in *Example 1*, except that Corporation M has also owned 10 percent of the one class of stock of foreign corporation B since 1987. Corporation B uses the calendar year as the taxable year. The remaining 90 percent of Corporation B's stock is owned by Corporation Z. Corporation B is not a controlled foreign corporation. Corporation B uses the u as its functional currency, and 1u equals $1 at all relevant times. In 1992, Corporation B has earnings and profits and pays foreign income taxes, a portion of which are attributable to high withholding tax interest, as defined in section 904(d)(2)(B)(i). Corporation B must reduce its pool of post-1986 foreign income taxes by the amount of tax imposed on high withholding tax interest in excess of 5 percent because that amount is not treated as a tax for purposes of section 902. See section 904(d)(2)(E)(ii) and paragraph (a)(8)(iii) of this section. Corporation B pays 50u in dividends in 1992, 5u to Corporation M and 45u to Corporation Z. Corporation M must compute its section 902(a) deemed paid taxes separately for the dividends it receives in 1992 from Corporation A (as computed in *Example 1*) and from Corporation B. Foreign income taxes of Corporation B deemed paid by Corporation M, and Corporation B's opening balances in

post-1986 undistributed earnings and post-1986 foreign income taxes for 1993 are computed as follows:

1. Assumed post-1986 undistributed earnings of Corporation B at start of 1992	(100u)
2. Assumed post-1986 foreign income taxes of Corporation B at start of 1992	$0
3. Assumed pre-tax earnings and profits of Corporation B for 1992 (including 50u of high withholding tax interest on which 5u of tax is withheld).	302.50u
4. Assumed foreign income taxes paid or accrued by Corporation B in 1992	102.50u
5. Post-1986 undistributed earnings in Corporation B for 1992 (pre-dividend) (Line 1 plus Line 3 minus Line 4)	100u
6. Amount of foreign income tax of Corporation B imposed on high withholding tax interest in excess of 5% (5u withholding tax—[5% × 50u high withholding tax interest]).	2.50u
7. Post-1986 foreign income taxes in Corporation B for 1992 (pre-dividend) (Line 2 plus [Line 4 minus Line 6 translated at the appropriate exchange rate]).	$100
8. Dividends paid out of post-1986 undistributed earnings to Corporation M in 1992	5u
9. Percentage of Corporation B's post-1986 undistributed earnings paid to Corporation M (Line 8 divided by Line 5).	5%
10. Foreign income taxes of Corporation B deemed paid by Corporation M under section 902(a) (Line 7 multiplied by Line 9).	$5
11. Total dividends paid out of post-1986 undistributed earnings of Corporation B to all shareholders in 1992	50u
12. Percentage of Corporation B's post-1986 undistributed earnings paid to all shareholders in 1992 (Line 11 divided by Line 5).	50%
13. Post-1986 foreign income taxes of Corporation B paid on or with respect to post-1986 undistributed earnings distributed to all shareholders in 1992 (Line 7 multiplied by Line 12).	$50
14. Corporation B's post-1986 undistributed earnings at start of 1993 (Line 5 minus Line 11)	50u
15. Corporation B's post-1986 foreign income taxes at start of 1993 (Line 7 minus Line 13)	$50

(ii) For 1992, as computed in *Example 1*, Corporation M is deemed to have paid $2 of the post-1986 foreign income taxes paid by Corporation A and includes $2 in gross income as a dividend under section 78. Both the income inclusion and the credit are subject to a separate limitation for dividends from Corporation A, a noncontrolled section 902 corporation. Corporation M also is deemed to have paid $5 of the post-1986 foreign income taxes paid by Corporation B and includes $5 in gross income as a deemed dividend under section 78. Both the income inclusion and the foreign taxes deemed paid are subject to a separate limitation for dividends from Corporation B, a noncontrolled section 902 corporation.

Example 3. (i) Since 1987, domestic corporation M has owned 50 percent of the one class of stock of foreign corporation A. The remaining 50 percent of Corporation A is owned by foreign corporation Z. For the same time period, Corporation A has owned 40 percent of the one class of stock of foreign corporation B, and Corporation B has owned 30 percent of the one class of stock of foreign corporation C. The remaining 60 percent of Corporation B is owned by foreign corporation Y, and the remaining 70 percent of Corporation C is owned by foreign corporation X. Corporations A, B, and C are not controlled foreign corporations. Corporations A, B, and C use the u as their functional currency, and 1u equals $1 at all relevant times. Corporation B uses a fiscal year ending June 30 as its taxable year; all other corporations use the calendar year as the taxable year. On February 1, 1992, Corporation C pays a 500u dividend out of post-1986 undistributed earnings, 150u to Corporation B and 350u to Corporation X. On February 15, 1992, Corporation B pays a 300u dividend out of post-1986 undistributed earnings computed as of the close of Corporation B's fiscal year ended June 30, 1992, 120u to Corporation A and 180u to Corporation Y. On August 15, 1992, Corporation A pays a 200u dividend out of post-1986 undistributed earnings, 100u to Corporation M and 100u to Corporation Z. In computing foreign taxes deemed paid by Corporations B and A, section 78 does not apply and Corporations B and A thus do not have to include the foreign taxes deemed paid in earnings and profits. See paragraph (c)(2)(ii) of this section. Foreign income taxes deemed paid by Corporations B, A and M, and the foreign corporations' opening balances in post-1986 undistributed earnings and post-1986 foreign income taxes for Corporation B's fiscal year beginning July 1, 1992, and Corporation C's and Corporation A's 1993 calendar years are computed as follows:

A. Corporation C (third-tier corporation):

1. Assumed post-1986 undistributed earnings in Corporation C at start of 1992	1300u
2. Assumed post-1986 foreign income taxes in Corporation C at start of 1992	$500
3. Assumed pre-tax earnings and profits of Corporation C for 1992	500u
4. Assumed foreign income taxes paid or accrued in 1992	300u
5. Post-1986 undistributed earnings in Corporation C for 1992 (pre-dividend) (Line 1 plus Line 3 minus Line 4).	1500u
6. Post-1986 foreign income taxes in Corporation C for 1992 (pre-dividend) (Line 2 plus Line 4 translated at the appropriate exchange rates).	$800
7. Dividends paid out of post-1986 undistributed earnings of Corporation C to Corporation B in 1992	150u

8. Percentage of Corporation C's post-1986 undistributed earnings paid to Corporation B (Line 7 divided by Line 5).	10%
9. Foreign income taxes of Corporation C deemed paid by Corporation B under section 902(b)(2) (Line 6 multiplied by Line 8).	$80
10. Total dividends paid out of post-1986 undistributed earnings of Corporation C to all shareholders in 1992.	500u
11. Percentage of Corporation C's post-1986 undistributed earnings paid to all shareholders in 1992 (Line 10 divided by Line 5).	33.33%
12. Post-1986 foreign income taxes paid with respect to post-1986 undistributed earnings distributed to all shareholders in 1992 (Line 6 multiplied by Line 11).	$266.66
13. Post-1986 undistributed earnings in Corporation C at start of 1993 (Line 5 minus Line 10)	1000u
14. Post-1986 foreign income taxes in Corporation C at start of 1993 (Line 6 minus Line 12)	$533.34
B. Corporation B (second-tier corporation):	
1. Assumed post-1986 undistributed earnings in Corporation B as of July 1, 1991	0
2. Assumed post-1986 foreign income taxes in Corporation B as of July 1, 1991	0
3. Assumed pre-tax earnings and profits of Corporation B for fiscal year ended June 30, 1992, (including 150u dividend from Corporation B).	1000u
4. Assumed foreign income taxes paid or accrued by Corporation B in fiscal year ended June 30, 1992	200u
5. Foreign income taxes of Corporation C deemed paid by Corporation B in its fiscal year ended June 30, 1992 (Part A, Line 9 of paragraph (i) of this Example 3).	$80
6. Post-1986 undistributed earnings in Corporation B for fiscal year ended June 30, 1992 (pre-dividend) (Line 1 plus Line 3 minus Line 4).	800u
7. Post-1986 foreign income taxes in Corporation B for fiscal year ended June 30, 1992 (pre-dividend) (Line 2 plus Line 4 translated at the appropriate exchange rates plus Line 5).	$280
8. Dividends paid out of post-1986 undistributed earnings of Corporation B to Corporation A on February 15, 1992.	120u
9. Percentage of Corporation B's post-1986 undistributed earnings for fiscal year ended June 30, 1992, paid to Corporation A (Line 8 divided by Line 6).	15%
10. Foreign income taxes paid and deemed paid by Corporation B as of June 30, 1992, deemed paid by Corporation A under section 902(b)(1) (Line 7 multiplied by Line 9).	$42
11. Total dividends paid out of post-1986 undistributed earnings of Corporation B for fiscal year ended June 30, 1992.	300u
12. Percentage of Corporation B's post-1986 undistributed earnings for fiscal year ended June 30, 1992, paid to all shareholders (Line 11 divided by Line 6).	37.5%
13. Post-1986 foreign income taxes paid and deemed paid with respect to post-1986 undistributed earnings distributed to all shareholders during Corporation B's fiscal year ended June 30, 1992 (Line 7 multiplied by Line 12).	$105
14. Post-1986 undistributed earnings in Corporation B as of July 1, 1992 (Line 6 minus Line 11)	500u
15. Post-1986 foreign income taxes in Corporation B as of July 1, 1992 (Line 7 minus Line 13)	$175
C. Corporation A (first-tier corporation):	
1. Assumed post-1986 undistributed earnings in Corporation A at start of 1992	250u
2. Assumed post-1986 foreign income taxes in Corporation A at start of 1992	$100
3. Assumed pre-tax earnings and profits of Corporation A for 1992 (including 120u dividend from Corporation B).	250u
4. Assumed foreign income taxes paid or accrued by Corporation A in 1992	100u
5. Foreign income taxes paid or deemed paid by Corporation B as of June 30, 1992, that are deemed paid by Corporation A in 1992 (Part B, Line 10 of paragraph (i) of this Example 3).	$42
6. Post-1986 undistributed earnings in Corporation A for 1992 (pre-dividend) (Line 1 plus Line 3 minus Line 4).	400u
7. Post-1986 foreign income taxes in Corporation A for 1992 (pre-dividend) (Line 2 plus Line 4 translated at the appropriate exchange rates plus Line 5).	$242
8. Dividends paid out of post-1986 undistributed earnings of Corporation A to Corporation M on August 15, 1992.	100u
9. Percentage of Corporation A's post-1986 undistributed earnings paid to Corporation M in 1992 (Line 8 divided by Line 6).	25%
10. Foreign income taxes paid and deemed paid by Corporation A in 1992 that are deemed paid by Corporation M under section 902(a) (Line 7 multiplied by Line 9).	$60.50
11. Total dividends paid out of post-1986 undistributed earnings of Corporation A to all shareholders in 1992.	200u
12. Percentage of Corporation A's post-1986 undistributed earnings paid to all shareholders in 1992 (Line 11 divided by Line 6).	50%
13. Post-1986 foreign income taxes paid and deemed paid by Corporation A with respect to post-1986 undistributed earnings distributed to all shareholders in 1992 (Line 7 multiplied by Line 12).	$121
14. Post-1986 undistributed earnings in Corporation A at start of 1993 (Line 6 minus Line 11)	200u
15. Post-1986 foreign income taxes in Corporation A at start of 1993 (Line 7 minus Line 13)	$121

(ii) Corporation M is deemed, under section 902(a) and paragraph (b) of this section, to have paid $60.50 of post-1986 foreign income taxes paid, or deemed paid, by Corporation A on or with respect to its post-1986 undistributed earnings (Part C, Line 10) and Corporation M includes that amount in gross income as a dividend under section 78. Both the income inclusion and the credit are subject to a separate limitation for dividends from Corporation A, a noncontrolled section 902 corporation.

Example 4. (i) Since 1987, domestic corporation M has owned 100 percent of the voting

stock of controlled foreign corporation A, and Corporation A has owned 100 percent of the voting stock of controlled foreign corporation B. Corporations M, A and B use the calendar year as the taxable year. Corporations A and B are organized in the same foreign country and use the u as their functional currency. 1u equals $1 at all relevant times. Assume that all of the earnings of Corporations A and B are general limitation earnings and profits within the meaning of section 904(d)(2)(I), and that neither Corporation A nor Corporation B has any previously taxed income accounts. In 1992, Corporation B pays a dividend of 150u to Corporation A out of post-1986 undistributed earnings, and Corporation A computes an amount of foreign taxes deemed paid under section 902(b)(1). The dividend is not subpart F income to Corporation A because section 954(c)(3)(B)(i) (the same country dividend exception) applies. Pursuant to paragraph (c)(2)(ii) of this section, Corporation A is not required to include the deemed paid taxes in earnings and profits. Corporation A has no pre-1987 accumulated profits and a deficit in post-1986 undistributed earnings for 1992. In 1992, Corporation A pays a dividend of 100u to Corporation M out of its earnings and profits for 1992 (current earnings and profits). Under paragraph (b)(4) of this section, Corporation M is not deemed to have paid any of the foreign income taxes paid or deemed paid by Corporation A because Corporation A has a deficit in post-1986 undistributed earnings as of December 31, 1992, and the sum of its current plus accumulated profits is less than zero. Note that if instead of paying a dividend to Corporation A in 1992, Corporation B had made an additional investment of $150 in United States property under section 956, that amount would have been included in gross income by Corporation M under section 951(a)(1)(B) and Corporation M would have been deemed to have paid $50 of foreign income taxes paid by Corporation B. See sections 951(a)(1)(B) and 960. Foreign income taxes of Corporation B deemed paid by Corporation A and the opening balances in post-1986 undistributed earnings and post-1986 foreign income taxes for Corporation A and Corporation B for 1993 are computed as follows:

A. Corporation B (second-tier corporation):	
1. Assumed post-1986 undistributed earnings in Corporation B at start of 1992	200u
2. Assumed post-1986 foreign income taxes in Corporation B at start of 1992	$50
3. Assumed pre-tax earnings and profits of Corporation B for 1992	150u
4. Assumed foreign income taxes paid or accrued in 1992	50u
5. Post-1986 undistributed earnings in Corporation B for 1992 (pre-dividend) (Line 1 plus Line 3 minus Line 4).	300u
6. Post-1986 foreign income taxes in Corporation B for 1992 (pre-dividend) (Line 2 plus Line 4 translated at the appropriate exchange rates).	$100
7. Dividends paid out of post-1986 undistributed earnings of Corporation B to Corporation A in 1992	150u
8. Percentage of Corporation B's post-1986 undistributed earnings paid to Corporation A (Line 7 divided by Line 5).	50%
9. Foreign income taxes of Corporation B deemed paid by Corporation A under section 902(b)(1) (Line 6 multiplied by Line 8).	$50
10. Post-1986 undistributed earnings in Corporation B at start of 1993 (Line 5 minus Line 7)	150u
11. Post-1986 foreign income taxes in Corporation B at start of 1993 (Line 6 minus Line 9)	$50
B. Corporation A (first-tier corporation):	
1. Assumed post-1986 undistributed earnings in Corporation A at start of 1992	(200u)
2. Assumed post-1986 foreign income taxes in Corporation A at start of 1992	0
3. Assumed pre-tax earnings and profits of Corporation A for 1992 (including 150u dividend from Corporation B).	200u
4. Assumed foreign income taxes paid or accrued by Corporation A in 1992	40u
5. Foreign income taxes paid by Corporation B in 1992 that are deemed paid by Corporation A (Part A, Line 9 of paragraph (i) of this Example 4).	$50
6. Post-1986 undistributed earnings in Corporation A for 1992 (pre-dividend) (Line 1 plus Line 3 minus Line 4).	(40u)
7. Post-1986 foreign income taxes in Corporation A for 1992 (pre-dividend) (Line 2 plus Line 4 translated at the appropriate exchange rates plus Line 5).	$90
8. Dividends paid out of current earnings and profits of Corporation A for 1992	100u
9. Percentage of post-1986 undistributed earnings of Corporation A paid to Corporation M in 1992 (Line 8 divided by the greater of Line 6 or zero).	0
10. Foreign income taxes paid and deemed paid by Corporation A in 1992 that are deemed paid by Corporation M under section 902(a) (Line 7 multiplied by Line 9).	0
11. Post-1986 undistributed earnings in Corporation A at start of 1993 (line 6 minus line 8)	(140u)
12. Post-1986 foreign income taxes in Corporation A at start of 1993 (Line 7 minus Line 10)	$90

(ii) For 1993, Corporation A has 500u of earnings and profits on which it pays 160u of foreign income taxes. Corporation A receives no dividends from Corporation B, and pays a 100u dividend to Corporation M. The 100u dividend to Corporation M carries with it some of the foreign income taxes paid and deemed paid by Corporation A in 1992, which were not deemed paid by Corporation M in 1992 because Corporation A had no post-1986 undistributed earnings. Thus, for 1993, Corporation M is deemed to have paid $125 of post-

1986 foreign income taxes paid and deemed paid by Corporation A and includes that amount in gross income as a dividend under section 78, determined as follows:

1. Post-1986 undistributed earnings in Corporation A at start of 1993	(140u)
2. Post-1986 foreign income taxes in Corporation A at start of 1993	$90
3. Pre-tax earnings and profits of Corporation A for 1993	500u
4. Foreign income taxes paid or accrued by Corporation A in 1993	160u
5. Post-1986 undistributed earnings in Corporation A for 1993 (pre-dividend) (Line 1 plus Line 3 minus Line 4)	200u
6. Post-1986 foreign income taxes in Corporation A for 1993 (pre-dividend) (Line 2 plus Line 4 translated at the appropriate exchange rates).	$250
7. Dividends paid out of post-1986 undistributed earnings of Corporation A to Corporation M in 1993	100u
8. Percentage of post-1986 undistributed earnings of Corporation A paid to Corporation M in 1993 (Line 7 divided by Line 5).	50%
9. Foreign income taxes paid and deemed paid by Corporation A that are deemed paid by Corporation M in 1993 (Line 6 multiplied by Line 8).	$125
10. Post-1986 undistributed earnings in Corporation A at start of 1994 (Line 5 minus Line 7)	100u
11. Post-1986 foreign income taxes in Corporation A at start of 1994 (Line 6 minus Line 9)	$125

Example 5. (i) Since 1987, domestic corporation M has owned 100 percent of the voting stock of controlled foreign corporation A. Corporation M also conducts operations through a foreign branch. Both Corporation A and Corporation M use the calendar year as the taxable year. Corporation A uses the u as its functional currency and 1u equals $1 at all relevant times. Corporation A has no subpart F income, as defined in section 952, and no increase in earnings invested in United States property under section 956 for 1992. Corporation A also has no previously taxed income accounts. Corporation A has general limitation income and high withholding tax interest income that, by operation of section 954(b)(4), does not constitute foreign base company income under section 954(a). Because Corporation A is a controlled foreign corporation, it is not required to reduce post-1986 foreign income taxes by foreign taxes paid or accrued with respect to high withholding tax interest in excess of 5 percent. See §1.902–1(a)(8)(iii). Corporation A pays a 60u dividend to Corporation M in 1992. For 1992, Corporation M is deemed, under paragraph (b) of this section, to have paid $24 of the post-1986 foreign income taxes paid by Corporation A and includes that amount in gross income under section 78 as a dividend, determined as follows:

1. Assumed post-1986 undistributed earnings in Corporation A at start of 1992 attributable to:	
(a) Section 904(d)(1)(B) high withholding tax interest	20u
(b) Section 904(d)(1)(I) general limitation income	55u
2. Assumed post-1986 foreign income taxes in Corporation A at start of 1992 attributable to:	
(a) Section 904(d)(1)(B) high withholding tax interest	$5
(b) Section 904(d)(1)(I) general limitation income	$20
3. Assumed pre-tax earnings and profits of Corporation A for 1992 attributable to:	
(a) Section 904(d)(1)(B) high withholding tax interest	20u
(b) Section 904(d)(1)(I) general limitation income	20u
4. Assumed foreign income taxes paid or accrued in 1992 on or with respect to:	
(a) Section 904(d)(1)(B) high withholding tax interest	10u
(b) Section 904(d)(1)(I) general limitation income	5u
5. Post-1986 undistributed earnings in Corporation A for 1992 (pre-dividend) attributable to:	
(a) Section 904(d)(1)(B) high withholding tax interest (Line 1(a) + Line 3(a) minus Line 4(a))	30u
(b) Section 904(d)(1)(I) general limitation income (Line 1(b) + Line 3(b) minus Line 4(b))	70u
(c) Total	100u
6. Post-1986 foreign income taxes in Corporation A for 1992 (pre-dividend) attributable to:	
(a) Section 904(d)(1)(B) high withholding tax interest (Line 2(a) + Line 4(a) translated at the appropriate exchange rates).	$15
(b) Section 904(d)(1)(I) general limitation income (Line 2(b) + Line 4(b) translated at the appropriate exchange rates).	$25
7. Dividends paid to Corporation M in 1992	60u
8. Dividends paid to Corporation M in 1992 attributable to section 904(d) separate categories pursuant to §1.904–5(d):	
(a) Dividends paid to Corporation M in 1992 attributable to section 904(d)(1)(B) high withholding tax interest (Line 7 multiplied by Line 5(a) divided by Line 5(c)).	18u
(b) Dividends paid to Corporation M in 1992 attributable to section 904(d)(1)(I) general limitation income (Line 7 multiplied by Line 5(b) divided by Line 5(c)).	42u
9. Percentage of Corporation A's post-1986 undistributed earnings for 1992 paid to Corporation M attributable to:	
(a) Section 904(d)(1)(B) high withholding tax interest (Line 8(a) divided by Line 5(a))	60%
(b) Section 904(d)(1)(I) general limitation income (Line 8(b) divided by Line 5(b))	60%
10. Foreign income taxes of Corporation A deemed paid by Corporation M under section 902(a) attributable to:	
(a) Foreign income taxes of Corporation A deemed paid by Corporation M under section 902(a) with respect to section 904(d)(1)(B) high withholding tax interest (Line 6(a) multiplied by Line 9(a)).	$9

(b) Foreign income taxes of Corporation A deemed paid by Corporation M under section 902(a) with respect to section 904(d)(1)(I) general limitation income (Line 6(b) multiplied by Line 9(b)).	$15
11. Post-1986 undistributed earnings in Corporation A at start of 1993 attributable to:	
(a) Section 904(d)(1)(B) high withholding tax interest (Line 5(a) minus Line 8(a))	12u
(b) Section 904(d)(1)(I) general limitation income (Line 5(b) minus Line 8(b))	28u
12. Post-1986 foreign income taxes in Corporation A at start of 1989 allocable to:	
(a) Section 904(d)(1)(B) high withholding tax interest (Line 6(a) minus Line 10(a))	$6
(b) Section 904(d)(1)(I) general limitation income (Line 6(b) minus Line 10(b))	$10

(ii) For purposes of computing Corporation M's foreign tax credit limitation, the post-1986 foreign income taxes of Corporation A deemed paid by Corporation M with respect to income in separate categories will be added to the foreign income taxes paid or accrued by Corporation M associated with income derived from Corporation M's branch operation in the same separate categories. The dividend (and the section 78 inclusion with respect to the dividend) will be treated as income in separate categories and added to Corporation M's other income, if any, attributable to the same separate categories. See section 904(d) and § 1.904–6.

(g) *Effective/applicability dates.* This section applies to any distribution made in and after a foreign corporation's first taxable year beginning on or after January 1, 1987, except that the provisions of paragraphs (a)(4)(ii), (a)(6), (a)(7), (a)(8)(i), and (c)(8) of this section and, except as provided in § 1.904–7(f)(9), the provisions of paragraph (d) of this section apply to distributions made in taxable years of foreign corporations ending on or after April 20, 2009. *See* 26 CFR 1.902–1T(a)(4)(ii), (a)(6), (a)(7), (a)(8)(i), and (c)(8) (revised as of April 1, 2009) for rules applicable to distributions made in taxable years of foreign corporations beginning after April 25, 2006, and ending before April 20, 2009, and 26 CFR 1.902–1T(d), except as provided in 26 CFR 1.904–7T(f)(9) (revised as of April 1, 2009), for rules applicable to distributions made in taxable years of foreign corporations beginning after December 31, 2002, and ending before April 20, 2009.

[T.D. 8708, 62 FR 928, Jan. 7, 1997, as amended by T.D. 8916, 66 FR 274, Jan. 3, 2001; T.D. 9260, 71 FR 24526, Apr. 25, 2006; 71 FR 77264, Dec. 26, 2006; T.D. 9452, 74 FR 27875, June 11, 2009]

§ 1.902–2 Treatment of deficits in post-1986 undistributed earnings and pre-1987 accumulated profits of a first- or lower-tier corporation for purposes of computing an amount of foreign taxes deemed paid under § 1.902–1.

(a) *Carryback of deficits in post-1986 undistributed earnings of a first- or lower-tier corporation to pre-effective date taxable years*—(1) *Rule.* For purposes of computing foreign income taxes deemed paid under § 1.902–1(b) with respect to dividends paid by a first- or lower-tier corporation, when there is a deficit in the post-1986 undistributed earnings of that corporation and the corporation makes a distribution to shareholders that is a dividend or would be a dividend if there were current or accumulated earnings and profits, then the post-1986 deficit shall be carried back to the most recent pre-effective date taxable year of the first- or lower-tier corporation with positive accumulated profits computed under section 902. See § 1.902–3(e). For purposes of this § 1.902–2, a pre-effective date taxable year is a taxable year beginning before January 1, 1987, or a taxable year beginning after December 31, 1986, if the special effective date of § 1.902–1(a)(13) applies. The deficit shall reduce the section 902 accumulated profits in the most recent pre-effective date year to the extent thereof, and any remaining deficit shall be carried back to the next preceding year or years until the deficit is completely allocated. The amount carried back shall reduce the deficit in post-1986 undistributed earnings. Any foreign income taxes paid in a post-effective date year will not be carried back to pre-effective date taxable years or removed from post-1986 foreign income taxes. See section 960 and the regulations under that section for rules governing the carryback of deficits and the computation of foreign income taxes deemed

paid with respect to deemed income inclusions from controlled foreign corporations.

(2) *Examples*. The following examples illustrate the rules of this paragraph (a):

Example 1. (i) From 1985 through 1990, domestic corporation M owns 10 percent of the one class of stock of foreign corporation A. The remaining 90 percent of Corporation A's stock is owned by Z, a foreign corporation. Corporation A is not a controlled foreign corporation and uses the u as its functional currency. 1u equals $1 at all relevant times. Both Corporation A and Corporation M use the calendar year as the taxable year. Corporation A has pre-1987 accumulated profits and post-1986 undistributed earnings or deficits in post-1986 undistributed earnings, pays pre-1987 and post-1986 foreign income taxes, and pays dividends as summarized below:

Taxable year	1985	1986	1987	1988	1989	1990
Current E & P (Deficits) of Corp. A.	150u	150u	(100u)	100u	0	0
Current Plus Accumulated E & P of Corp. A.	150u	300u	200u	250u	250u	200u
Post-'86 Undistributed Earnings of Corp. A.			(100u)	100u	100u	50u
Post-'86 Undistributed Earnings of Corp. A Reduced By Current Year Dividend Distributions (increased by deficit carryback).			0	100u	50u	50u
Foreign Income Taxes of Corp. A (Annual).	120u	120u	$10	$50	0	0
Post-'86 Foreign Income Taxes of Corp. A.			$10	$60	$60	$30
12/31 Distributions to Corp. M	0	0	5u	0	5u	0
12/31 Distributions to Corp. Z	0	0	45u	0	45u	0

(ii) On December 31, 1987, Corporation A distributes a 5u dividend to Corporation M and a 45u dividend to Corporation Z. At that time Corporation A has a deficit of (100u) in post-1986 undistributed earnings and $10 of post-1986 foreign income taxes. The (100u) deficit (but not the post-1986 foreign income taxes) is carried back to offset the accumulated profits of 1986 and removed from post-1986 undistributed earnings. The accumulated profits for 1986 are reduced to 50u (150u − 100u). The dividend is paid out of the reduced 1986 accumulated profits. Foreign taxes deemed paid by Corporation M with respect to the 5u dividend are 12u (120u × (5u / 50u)). See §1.902–1(b)(3). Corporation M must include 12u in gross income (translated under the rule applicable to foreign income taxes paid on earnings accumulated in pre-effective date years) under section 78 as a dividend. Both the income inclusion and the foreign taxes deemed paid are subject to a separate limitation for dividends from Corporation A, a noncontrolled section 902 corporation. No accumulated profits remain in Corporation A with respect to 1986 after the carryback of the 1987 deficit and the December 31, 1987, dividend distributions to Corporations M and Z.

(iii) On December 31, 1989, Corporation A distributes a 5u dividend to Corporation M and a 45u dividend to Corporation Z. At that time Corporation A has 100u of post-1986 undistributed earnings and $60 of post-1986 foreign income taxes. Therefore, the dividend is considered paid out of Corporation A's post-1986 undistributed earnings. Foreign taxes deemed paid by Corporation M with respect to the 5u dividend are $3 ($60 × 5%[5u / 100u]). Corporation M must include $3 in gross income under section 78 as a dividend. Both the income inclusion and the foreign taxes deemed paid are subject to a separate limitation for dividends from noncontrolled section 902 corporation A. Corporation A's post-1986 undistributed earnings as of January 1, 1990, are 50u (100u − 50u). Corporation A's post-1986 foreign income taxes must be reduced by the amount of foreign taxes that would have been deemed paid if both Corporations M and Z were eligible to compute an amount of deemed paid taxes. Section 1.902–1(a)(8)(i). The amount of foreign income taxes that would have been deemed paid if both Corporations M and Z were eligible to compute an amount of deemed paid taxes on the 50u dividend distributed by Corporation A is $30 ($60 × 50%[50u / 100u]). Thus, post-1986 foreign income taxes as of January 1, 1990, are $30 ($60 − $30).

Example 2. The facts are the same as in *Example 1*, except that Corporation A has a deficit in its post-1986 undistributed earnings of (150u) on December 31, 1987. The deficit is carried back to 1986 and reduces accumulated profits for that year to -0-. Thus, the foreign income taxes paid with respect to the 1986 accumulated profits will never be deemed paid. The 1987 dividend is deemed to be out of Corporation A's 1985 accumulated profits. Foreign taxes deemed paid by Corporation M under section 902 with respect to the 5u dividend paid on December 31, 1987, are 4u (120u × 5u / 150u). See §1.902–1(b)(3). As a result of

the December 31, 1987, dividend distributions, 100u (150u − 50u) of accumulated profits and 80u (120u reduced by 40u[120u × 50u / 150u] of foreign taxes that would have been deemed paid had all of Corporation A's shareholders been eligible to compute an amount of foreign taxes deemed paid with respect to the dividend paid out of 1985 accumulated profits) remain in Corporation A with respect to 1985.

Example 3. (i) From 1986 through 1991, domestic corporation M owns 10 percent of the one class of stock of foreign corporation A. The remaining 90 percent of Corporation A's stock is owned by Corporation Z, a foreign corporation. Corporation A is not a controlled foreign corporation and uses the u as its functional currency. 1u equals $1 at all relevant times. Both Corporation A and Corporation M use the calendar year as the taxable year. Corporation A has pre-1987 accumulated profits and post-1986 undistributed earnings or deficits in post-1986 undistributed earnings, pays pre-1987 and post-1986 foreign income taxes, and pays dividends as summarized below:

Taxable year	1986	1987	1988	1989	1990	1991
Current E & P (Deficits) of Corp. A.	100u	(50u)	150u	75u	25u	0
Current Plus Accumulated E & P of Corp. A.	100u	50u	200u	175u	200u	80u
Post-'86 Undistributed Earnings of Corp. A.		(50u)	100u	75u	100u	0
Post-'86 Undistributed Earnings of Corp. A Reduced By Current Year Dividend Distributions (increased by deficit carryback).		(50u)	0	75u	0	0
Foreign Income Taxes (Annual) of Corp. A.	80u	0	$120	$20	$20	0
Post-'86 Foreign Income Taxes of Corp. A.		0	$120	$20	$40	0
12/31 Distributions to Corp. M	0	0	10u	0	12u	0
12/31 Distributions to Corp. Z	0	0	90u	0	108u	0

(ii) On December 31, 1988, Corporation A distributes a 10u dividend to Corporation M and a 90u dividend to Corporation Z. At that time Corporation A has 100u in its post-1986 undistributed earnings and $120 in its post-1986 foreign income taxes. Corporation M is deemed, under § 1.902–1(b)(1), to have paid $12 ($120 × 10%[10u / 100u]) of the post-1986 foreign income taxes paid by Corporation A and includes that amount in gross income under section 78 as a dividend. Both the income inclusion and the foreign taxes deemed paid are subject to a separate limitation for dividends from noncontrolled section 902 corporation A. Corporation A's post-1986 undistributed earnings as of January 1, 1989, are 0 (100u–100u). Its post-1986 foreign taxes as of January 1, 1989, also are 0, $120 reduced by $120 of foreign income taxes paid that would have been deemed paid if both Corporations M and Z were eligible to compute an amount of foreign taxes deemed paid on the dividend from Corporation A ($120 × 100%[100u / 100u]).

(iii) On December 31, 1990, Corporation A distributes a 12u dividend to Corporation M and a 108u dividend to Corporation Z. At that time Corporation A has 100u in its post-1986 undistributed earnings and $40 in its post-1986 foreign income taxes. The dividend is paid out of post-1986 undistributed earnings to the extent thereof (100u), and the remainder of 20u is paid out of 1986 accumulated profits. Under § 1.902–1(b)(2), the 12u dividend to Corporation M is deemed to be paid out of post-1986 undistributed earnings to the extent of 10u (100u × 12u / 120u) and the remaining 2u is deemed to be paid out of Corporation A's 1986 accumulated profits. Similarly, the 108u dividend to Corporation Z is deemed to be paid out of post-1986 undistributed earnings to the extent of 90u (100u × 108u / 120u) and the remaining 18u is deemed to be paid out of Corporation A's 1986 accumulated profits. Foreign income taxes deemed paid by Corporation M under section 902 with respect to the portion of the dividend paid out of post-1986 undistributed earnings are $4 ($40 × 10%[10u / 100u]), and foreign taxes deemed paid by Corporation M with respect to the portion of the dividend deemed paid out of 1986 accumulated profits are 1.6u (80u × 2u / 100u). Corporation M must include $4 plus 1.6u translated under the rule applicable to foreign income taxes paid on earnings accumulated in taxable years prior to the effective date of the Tax Reform Act of 1986 in gross income as a dividend under section 78. The income inclusion and the foreign income taxes deemed paid are subject to a separate limitation for dividends from noncontrolled section 902 Corporation A. As of January 1, 1991, Corporation A's post-1986 undistributed earnings are 0 (100u–100u). 80u (100u–20u) of accumulated profits remain with respect to 1986. Post-1986 foreign income taxes as of January 1, 1991, are 0, $40 reduced by $40 of foreign income taxes paid that would have been deemed paid if both Corporations M and Z were eligible to compute an amount of

deemed paid taxes on the 100u dividend distributed by Corporation A out of post-1986 undistributed earnings ($40 × 100%[100u / 100u]). Corporation A has 64u of foreign income taxes remaining with respect to 1986, 80u reduced by 16u [80u × 20u / 100u] of foreign income taxes that would have been deemed paid if Corporations M and Z both were eligible to compute an amount of deemed paid taxes on the 20u dividend distributed by Corporation A out of 1986 accumulated profits.

(b) *Carryforward of deficit in pre-1987 accumulated profits of a first- or lower-tier corporation to post-1986 undistributed earnings for purposes of section 902*—(1) *General rule*. For purposes of computing foreign income taxes deemed paid under §1.902–1(b) with respect to dividends paid by a first- or lower-tier corporation out of post-1986 undistributed earnings, the amount of a deficit in accumulated profits of the foreign corporation determined under section 902 as of the end of its last pre-effective date taxable year is carried forward and reduces post-1986 undistributed earnings on the first day of the foreign corporation's first taxable year beginning after December 31, 1986, or on the first day of the first taxable year in which the ownership requirements of section 902(c)(3)(B) and §1.902–1(a)(1) through (4) are met if the special effective date of §1.902–1(a)(13) applies. Any foreign income taxes paid with respect to a pre-effective date year shall not be carried forward and included in post-1986 foreign income taxes. Post-1986 undistributed earnings may not be reduced by the amount of a pre-1987 deficit in earnings and profits computed under section 964(a). See section 960 and the regulations under that section for rules governing the carryforward of deficits and the computation of foreign income taxes deemed paid with respect to deemed income inclusions from controlled foreign corporations. For translation rules governing carryforwards of deficits in pre-1987 accumulated profits to post-1986 taxable years of a foreign corporation with a dollar functional currency, see §1.985–6(d)(2).

(2) *Effect of pre-effective date deficit*. If a foreign corporation has a deficit in accumulated profits as of the end of its last pre-effective date taxable year, then the foreign corporation cannot pay a dividend out of pre-effective date years unless there is an adjustment made (for example, a refund of foreign taxes paid) that restores section 902 accumulated profits to a pre-effective date taxable year or years. Moreover, if a foreign corporation has a deficit in section 902 accumulated profits as of the end of its last pre-effective date taxable year, then no deficit in post-1986 undistributed earnings will be carried back under paragraph (a) of this section. For rules concerning carrybacks of eligible deficits from post-1986 undistributed earnings to reduce pre-1987 earnings and profits computed under section 964(a), see section 960 and the regulations under that section.

(3) *Examples*. The following examples illustrate the rules of this paragraph (b):

Example 1. (i) From 1984 through 1988, domestic corporation M owns 10 percent of the one class of stock of foreign corporation A. The remaining 90 percent of Corporation A's stock is owned by Corporation Z, a foreign corporation. Corporation A is not a controlled foreign corporation and uses the u as its functional currency. 1u equals $1 at all relevant times. Both Corporation A and Corporation M use the calendar year as the taxable year. Corporation A has pre-1987 accumulated profits or deficits in accumulated profits and post-1986 undistributed earnings, pays pre-1987 and post-1986 foreign income taxes, and pays dividends as summarized below:

Taxable year	1984	1985	1986	1987	1988
Current E & P (Deficits) of Corp. A	25u	(100u)	(25u)	200u	100u
Current Plus Accumulated E & P (Deficits) of Corp. A.	25u	(75u)	(100u)	100u	50u
Post-'86 Undistributed Earnings of Corp. A				100u	50u
Post-'86 Undistributed Earnings of Corp. A Reduced By Current Year Dividend Distributions (reduced by deficit carryforward).				(50u)	50u
Foreign Income Taxes (Annual) of Corp. A	20u	5u	0	$100	$50
Post-'86 Foreign Income Taxes of Corp. A				$100	$50
12/31 Distributions to Corp. M	0	0	0	15u	0
12/31 Distributions to Corp. Z	0	0	0	135u	0

(ii) On December 31, 1987, Corporation A distributes a 150u dividend, 15u to Corporation M and 135u to Corporation Z. Corporation A has 200u of current earnings and profits for 1987, but its post-1986 undistributed earnings are only 100u as a result of the reduction for pre-1987 accumulated deficits required under paragraph (b)(1) of this section. Corporation A has $100 of post-1986 foreign income taxes. Only 100u of the 150u distribution is a dividend out of post-1986 undistributed earnings. Foreign income taxes deemed paid by Corporation M in 1987 with respect to the 10u dividend attributable to post-1986 undistributed earnings, computed under §1.902–1(b), are $10 ($100 × 10%[10u/100u]). Corporation M includes this amount in gross income under section 78 as a dividend. Both the income inclusion and the foreign taxes deemed paid are subject to a separate limitation for dividends from noncontrolled section 902 corporation A. After the distribution, Corporation A has (50u) of post-1986 undistributed earnings (100u −150u) and -0- post-1986 foreign income taxes, $100 reduced by $100 of foreign income taxes paid that would have been deemed paid if both Corporations M and Z were eligible to compute an amount of deemed paid taxes on the 100u dividend distributed by Corporation A out of post-1986 undistributed earnings ($100 × 100%[100u / 100u]).

(iii) The remaining 50u of the 150u distribution cannot be deemed paid out of accumulated profits of a pre-1987 year because Corporation A has an accumulated deficit as of the end of 1986 that eliminated all pre-1987 accumulated profits. See paragraph (b)(2) of this section. The 50u is a dividend out of current earnings and profits under section 316(a)(2), but Corporation M is not deemed to have paid any additional foreign income taxes paid by Corporation A with respect to that 50u dividend out of current earnings and profits. See §1.902–1(b)(4).

Example 2. (i) From 1986 through 1991, domestic corporation M owns 10 percent of the one class of stock of foreign corporation A. The remaining 90 percent of Corporation A's stock is owned by Corporation Z, a foreign corporation. Corporation A is not a controlled foreign corporation and uses the u as its functional currency. 1u equals $1 at all relevant times. Both Corporation A and Corporation M use the calendar year as the taxable year. Corporation A has pre-1987 accumulated profits or deficits in accumulated profits and post-1986 undistributed earnings, pays post-1986 foreign income taxes, and pays dividends as summarized below:

Taxable year	1986	1987	1988	1989	1990
Current E & P (Deficits) of Corp. A	(100u)	150u	(150u)	100u	250u
Current Plus Accumulated E & P (Deficits) of Corp. A.	(100u)	50u	(200u)	(100u)	50u
Post-'86 Undistributed Earnings of Corp. A		50u	(200u)	(100u)	50u
Post-'86 Undistributed Earnings of Corp. A Reduced By Current Year Dividend Distributions (reduced by deficit carryforward).		(50u)	(200u)	(200u)	0
Foreign Income Taxes (Annual) of Corp. A	0	$120	0	$50	$100
Post-'86 Foreign Income Taxes of Corp. A		$120	0	$50	$150
12/31 Distributions to Corp. M	0	10u	0	10u	5u
12/31 Distributions to Corp. Z	0	90u	0	90u	45u

(ii) On December 31, 1987, Corporation A distributes a 10u dividend to Corporation M and a 90u dividend to Corporation Z. At the time of the distribution, Corporation A has 50u of post-1986 undistributed earnings and 150u of current earnings and profits. Thus, 50u of the dividend distribution (5u to Corporation M and 45u to Corporation Z) is a dividend out of post-1986 undistributed earnings. The remaining 50u is a dividend out of current earnings and profits under section 316(a)(2), but Corporation M is not deemed to have paid any additional foreign income taxes paid by Corporation A with respect to that 50u dividend out of current earnings and profits. See §1.902–1(b)(4). Note that even if there were no current earnings and profits in Corporation A, the remaining 50u of the 100u distribution cannot be deemed paid out of accumulated profits of a pre1987 year because Corporation A has an accumulated deficit as of the end of 1986 that eliminated all pre-1987 accumulated profits. See paragraph (b)(2) of this section. Corporation A has $120 of post-1986 foreign income taxes. Foreign taxes deemed paid by Corporation M under section 902 with respect to the 5u dividend out of post-1986 undistributed earnings are $12 ($120 × 10%[5u/50u]). Corporation M includes this amount in gross income as a dividend under section 78. Both the foreign taxes deemed paid and the deemed dividend are subject to a separate limitation for dividends from noncontrolled section 902 corporation A. As of January 1, 1988, Corporation A has (50u) in its post-1986 undistributed earnings (50u − 100u) and -0- in its post-1986 foreign income taxes, $120 reduced by $120 of foreign taxes that would have been deemed paid if both Corporations M and Z were eligible to compute an amount of deemed paid taxes on the dividend distributed by Corporation A out of post-1986 undistributed earnings ($120 × 100%[50u / 50u]).

(iii) On December 31, 1989, Corporation A distributes a 10u dividend to Corporation M and a 90u dividend to Corporation Z. Although the distribution is considered a dividend in its entirety out of 1989 earnings and profits pursuant to section 316(a)(2), post-1986 undistributed earnings are (100u). Accordingly, for purposes of section 902, Corporation M is deemed to have paid no post-1986 foreign income taxes. See § 1.902–1(b)(4). Corporation A's post-1986 undistributed earnings as of January 1, 1990, are (200u) ((100u) − 100u). Corporation A's post-1986 foreign income taxes are not reduced because no taxes were deemed paid.

(iv) On December 31, 1990, Corporation A distributes a 5u dividend to Corporation M and a 45u dividend to Corporation Z. At that time Corporation A has 50u of post-1986 undistributed earnings, and $150 of post-1986 foreign income taxes. Foreign taxes deemed paid by Corporation M under section 902 with respect to the 5u dividend are $15 ($150 × 10%[5u / 50u]). Post-1986 undistributed earnings as of January 1, 1991, are -0- (50u − 50u). Post-1986 foreign income taxes as of January 1, 1991, also are -0-, $150 reduced by $150 ($150 × 100%[50u / 50u]) of foreign income taxes that would have been deemed paid if both Corporations M and Z were eligible to compute an amount of deemed paid taxes on the 50u dividend.

[T.D. 8708, 62 FR 937, Jan. 7, 1997, as amended by T.D. 9260, 71 FR 24526, Apr. 25, 2006; 71 FR 77265, Dec. 26, 2006]

§ 1.902–3 Credit for domestic corporate shareholder of a foreign corporation for foreign income taxes paid with respect to accumulated profits of taxable years of the foreign corporation beginning before January 1, 1987.

(a) *Definitions*. For purposes of section 902 and §§ 1.902–3 and 1.902–4:

(1) *Domestic shareholder*. In the case of dividends received by a domestic corporation after December 31, 1964, from a foreign corporation, the term ''domestic shareholder'' means a domestic corporation which owns at least 10 percent of the voting stock of the foreign corporation at the time it receives a dividend from such foreign corporation.

(2) *First-tier corporation*. In the case of dividends received by a domestic shareholder after December 31, 1964, from a foreign corporation, the term ''first-tier corporation'' means a foreign corporation at least 10 percent of the voting stock of which is owned by a domestic shareholder at the time it receives a dividend from such foreign corporation. The term ''first-tier corporation'' also means a DISC or former DISC, but only with respect to dividends from the DISC or former DISC to the extent they are treated under sections 861(a)(2)(D) and 862(a)(2) as income from sources without the United States.

(3) *Second-tier corporation*. (i) In the case of dividends paid to a first-tier corporation by a foreign corporation after January 12, 1971 (i.e., the date of enactment of Pub. L. 91–684, 84 Stat. 2068), but only for purposes of applying this section for a taxable year of a domestic shareholder ending after that date, the foreign corporation is a ''second-tier corporation'' if at least 10 percent of its voting stock is owned by the first-tier corporation at the time the first-tier corporation receives the dividend.

(ii) In the case of dividends paid to a first-tier corporation by a foreign corporation after January 12, 1971, but only for purposes of applying this section for a taxable year of a domestic shareholder ending before January 13, 1971, or in the case of any dividend paid to a first-tier corporation by a foreign corporation before January 13, 1971, the foreign corporation is a ''second-tier corporation'' if at least 50 percent of its voting stock is owned by the first-tier corporation at the time the first-tier corporation receives the dividend.

(4) *Third-tier corporation*. In the case of dividends paid to a second-tier corporation (as defined in paragraph (a)(3)(i) or (ii) of this section) by a foreign corporation after January 12, 1971, but only for purposes of applying this section for a taxable year of a domestic shareholder ending after that date, the foreign corporation is a ''third-tier corporation'' if at least 10 percent of its voting stock is owned by the second-tier corporation at the time the second-tier corporation receives the dividend.

(5) *Foreign income taxes*. The term ''foreign income taxes'' means income, war profits, and excess profits taxes, and taxes included in the term ''income, war profits, and excess profits taxes'' by reason of section 903, imposed by a foreign country or a possession of the United States.

(6) *Dividend.* For the definition of the term ''dividend'' for purposes of applying section 902 and this section, see section 316 and the regulations thereunder.

(7) *Dividend received.* A dividend shall be considered received for purposes of section 902 and this section when the cash or other property is unqualifiedly made subject to the demands of the distributee. See § 1.301–1(b).

(b) *Domestic shareholder owning stock in a first-tier corporation*—(1) *In general.* (i) If a domestic shareholder receives dividends in any taxable year from its first-tier corporation, the credit for foreign income taxes allowed by section 901 includes, subject to the conditions and limitations of this section, the foreign income taxes deemed, in accordance with paragraph (b)(2) of this section, to be paid by such domestic shareholder for such year.

(ii) If dividends are received by a domestic shareholder from more than one first-tier corporation, the taxes deemed to be paid by such shareholder under section 902(a) and this paragraph (b) shall be computed separately with respect to the dividends received from each of such first-tier corporations.

(iii) Any taxes deemed paid by a domestic shareholder for the taxable year pursuant to section 902(a) and paragraph (b)(2) of this section shall, except as provided in § 1.960–3(b), be included in the gross income of such shareholder for such year as a dividend pursuant to section 78 and § 1.78–1. For the source of such a section 78 dividend, see paragraph (h)(1) of this section.

(iv) Any taxes deemed, under paragraph (b)(2) of this section, to be paid by the domestic shareholder shall be deemed to be paid by such shareholder only for purposes of the foreign tax credit allowed under section 901. See section 904 for other limitations on the amount of the credit.

(v) For rules relating to reduction of the amount of foreign income taxes deemed paid or accrued with respect to foreign mineral income, see section 901(e) and § 1.901–3.

(vi) For the nonrecognition as a foreign income tax for purposes of this section of certain income, profits, or excess profits taxes paid or accrued to a foreign country in connection with the purchase and sale of oil or gas extracted in such country, see section 901(f) and the regulations thereunder.

(vii) For rules relating to reduction of the amount of foreign income taxes deemed paid with respect to foreign oil and gas extraction income, see section 907(a) and the regulations thereunder.

(viii) See the regulations under sections 960, 962, and 963 for special rules relating to the application of section 902 in computing the foreign tax credit of United States shareholders of controlled foreign corporations.

(2) *Amount of foreign taxes deemed paid by a domestic shareholder.* To the extent dividends are paid by a first-tier corporation to its domestic shareholder out of accumulated profits, as defined in paragraph (e) of this section, for any taxable year, the domestic shareholder shall be deemed to have paid the same proportion of any foreign income taxes paid, accrued or deemed, in accordance with paragraph (c)(2) of this section, to be paid by such first-tier corporation on or with respect to such accumulated profits for such year which the amount of such dividends (determined without regard to the gross-up under section 78) bears to the amount by which such accumulated profits exceed the amount of such taxes (other than those deemed, under paragraph (c)(2) of this section, to be paid). For determining the amount of foreign income taxes paid or accrued by such first-tier corporation on or with respect to the accumulated profits for the taxable year of such first-tier corporation, see paragraph (f) of this section.

(c) *First-tier corporation owning stock in a second-tier corporation*—(1) *In general.* For purposes of applying section 902(a) and paragraph (b)(2) of this section, if a first-tier corporation receives dividends in any taxable year from its second-tier corporation, the foreign income taxes deemed to be paid by the first-tier corporation on or with respect to its own accumulated profits for such year shall be the amount determined in accordance with paragraph (c)(2) of this section. This paragraph (c) shall not apply unless the product of—

(i) The percentage of voting stock owned by the domestic shareholder in the first-tier corporation at the time that the domestic shareholder receives

dividends from the first-tier corporation in respect of which foreign income taxes are deemed to be paid by the domestic shareholder under paragraph (b)(1) of this section, and

(ii) The percentage of voting stock owned by the first-tier corporation in the second-tier corporation equals at least 5 percent. The percentage under paragraph (c)(1)(ii) of this section of voting stock owned by the first-tier corporation in the second-tier corporation is determined as of the time that the dividend distributed by the second-tier corporation is received by the first-tier corporation and thus included in accumulated profits of the first-tier corporation out of which dividends referred to in paragraph (c)(1)(i) of this section are distributed by the first-tier corporation to the domestic shareholder.

Example. On February 10, 1976, foreign corporation B pays a dividend out of its accumulated profits for 1975 to foreign corporation A. On February 16, 1976, the date on which it receives the dividend, A Corporation owns 40 percent of the voting stock of B Corporation. Both corporations use the calendar year as the taxable year. On June 1, 1976, A Corporation sells its stock in B Corporation. On January 17, 1977, A Corporation pays a dividend out of its accumulated profits for 1976 to domestic corporation M. M Corporation owns 30 percent of the voting stock of A Corporation on January 20, 1977, the date on which it receives the dividend. M Corporation uses a fiscal year ending on April 30 as the taxable year. On February 16, 1976, A Corporation satisfies the 10-percent stock ownership requirement referred to in paragraph (a)(3) of this section with respect to B Corporation, and on January 20, 1977, M Corporation satisfies the 10-percent stock-ownership requirement referred to in paragraph (a)(2) of this section with respect to A Corporation. The 5-percent requirement of this paragraph (c)(1) is also satisfied since 30 percent (the percentage of voting stock owned by M Corporation in A Corporation on January 20, 1977), when multiplied by 40 percent (the percentage of voting stock owned by A Corporation in B Corporation on February 16, 1976), equals 12 percent. Accordingly, for its taxable year ending on April 30, 1977, M Corporation is entitled to a credit for a portion of the foreign income taxes paid, accrued, or deemed to be paid, by A Corporation for 1976; and for 1976 A Corporation is deemed to have paid a portion of the foreign income taxes paid or accrued by B Corporation for 1975.

(2) *Amount of foreign taxes deemed paid by a first-tier corporation*. A first-tier corporation which receives dividends in any taxable year from its second-tier corporation shall be deemed to have paid for such year the same proportion of any foreign income taxes paid, accrued, or deemed, in accordance with paragraph (d)(2) of this section, to be paid by its second-tier corporation on or with respect to the accumulated profits, as defined in paragraph (e) of this section, for the taxable year of the second-tier corporation from which such dividends are paid which the amount of such dividends bears to the amount by which such accumulated profits of the second-tier corporation exceed the taxes so paid or accrued. For determining the amount of the foreign income taxes paid or accrued by such second-tier corporation on or with respect to the accumulated profits for the taxable year of such second-tier corporation, see paragraph (f) of this section.

(d) *Second-tier corporation owning stock in a third-tier corporation*—(1) *In general*. For purposes of applying section 902(b)(1) and paragraph (c)(2) of this section, if a second-tier corporation receives dividends in any taxable year from its third-tier corporation, the foreign income taxes deemed to be paid by the second-tier corporation on or with respect to its own accumulated profits for such year shall be the amount determined in accordance with paragraph (d)(2) of this section. This paragraph (d) shall not apply unless the product of—

(i) The percentage of voting stock arrived at in applying the 5-percent requirement of paragraph (c)(1) of this section with respect to dividends received by the first-tier corporation from the second-tier corporation, and

(ii) the percentage of voting stock owned by the second-tier corporation in the third-tier corporation equals at least 5 percent. The percentage under paragraph (d)(1)(ii) of this section of voting stock owned by the second-tier corporation in the third-tier corporation is determined as of the time that the dividend distributed by the third-tier corporation is received by the second-tier corporation and thus included in accumulated profits of the second-

tier corporation out of which dividends referred to in paragraph (d)(1)(i) of this section are distributed by the second-tier corporation to the first-tier corporation.

Example. On February 27, 1975, foreign corporation C pays a dividend out of its accumulated profits for 1974 to foreign corporation B. On March 3, 1975, the date on which it receives the dividend, B Corporation owns 50 percent of the voting stock of C Corporation. On February 10, 1976, B Corporation pays a dividend out of its accumulated profits for 1975 to foreign corporation A. On February 16, 1976, the date on which it receives the dividend, A Corporation owns 40 percent of the voting stock of B Corporation. All three corporations use the calendar year as the taxable year. On January 17, 1977, A Corporation pays a dividend out of its accumulated profits for 1976 to domestic corporation M. M Corporation owns 30 percent of the voting stock of A Corporation on January 20, 1977, the date on which it receives the dividend. M Corporation uses a fiscal year ending on April 30 as the taxable year. On February 16, 1976, A Corporation satisfies the 10-percent stock ownership requirement referred to in paragraph (a)(3) of this section with respect to B Corporation, and on January 20, 1977, M Corporation satisfies the 10-percent stock-ownership requirement referred to in paragraph (a)(2) of this section with respect to A Corporation. The 5-percent requirement of paragraph (c)(1) of this section is also satisfied since 30 percent (the percentage of voting stock owned by M Corporation in A Corporation on January 20, 1977), when multiplied by 40 percent (the percentage of voting stock owned by A Corporation in B Corporation on February 16, 1976), equals 12 percent. On March 3, 1975, B Corporation satisfies the 10 percent stock ownership requirement referred to in paragraph (a)(4) of this section with respect to C Corporation. The 5-percent requirement of this paragraph (d)(1) is also satisfied since 12 percent (the percentage of voting stock arrived at in applying the 5-percent requirement of paragraph (c)(1) of this section with respect to the dividends received by A Corporation from B Corporation on February 16, 1976), when multiplied by 50 percent (the percentage of voting stock owned by B Corporation in C Corporation on March 3, 1975), equals 6 percent. Accordingly, for its taxable year ending on April 30, 1977, M Corporation is entitled to a credit for a portion of the foreign income taxes paid, accrued, or deemed to be paid, by A Corporation for 1976; for 1976 A Corporation is deemed to have paid a portion of the foreign income taxes paid, accrued, or deemed to be paid, by B Corporation for 1975; and for 1975 B Corporation is deemed to have paid a portion of the foreign income taxes paid or accrued by C Corporation for 1974.

(2) *Amount of foreign taxes deemed paid by a second-tier corporation*. For purposes of applying paragraph (c)(2) of this section to a first-tier corporation, a second-tier corporation which receives dividends in its taxable year from its third-tier corporation shall be deemed to have paid for such year the same proportion of any foreign income taxes paid or accrued by its third-tier corporation on or with respect to the accumulated profits, as defined in paragraph (e) of this section, for the taxable year of the third-tier corporation from which such dividends are paid which the amount of such dividends bears to the amount by which such accumulated profits of the third-tier corporation exceed the taxes so paid or accrued. For determining the amount of the foreign income taxes paid or accrued by such third-tier corporation on or with respect to the accumulated profits for the taxable year of such third-tier corporation, see paragraph (f) of this section.

(e) *Determination of accumulated profits of a foreign corporation*. The accumulated profits for any taxable year of a first-tier corporation and the accumulated profits for any taxable year of a second-tier or third-tier corporation, which are taken into account in applying paragraph (c)(2) or (d)(2) of this section with respect to such first-tier corporation, shall be the sum of—

(1) The earnings and profits of such corporation for such year, and

(2) The foreign income taxes imposed on or with respect to the gains, profits, and income to which such earnings and profits are attributable.

(f) *Taxes paid on or with respect to accumulated profits of a foreign corporation*. For purposes of this section, the amount of foreign income taxes paid or accrued on or with respect to the accumulated profits of a foreign corporation for any taxable year shall be the entire amount of the foreign income taxes paid or accrued for such year on or with respect to such gains, profits, and income. For purposes of this paragraph (f), the gains, profits, and income of a foreign corporation for any taxable

year shall be determined after reduction by any income, war profits, or excess profits taxes imposed on or with respect to such gains, profits, and income by the United States.

(g) *Determination of earning and profits of a foreign corporation*—(1) *Taxable year to which section 963 does not apply*. For purposes of this section, the earnings and profits of a foreign corporation for any taxable year beginning after December 31, 1962, other than a taxable year to which paragraph (g)(2) of this section applies, may, if the domestic shareholder chooses, be determined under the rules provided by §1.964–1 exclusive of paragraphs (d) and (e) of such section. The translation of amounts so determined into United States dollars or other foreign currency shall be made at the proper exchange rate for the date of distribution with respect to which the determination is made.

(2) *Taxable year to which section 963 applies*. For any taxable year of a foreign corporation with respect to which there applies under §1.963–1(c)(1) an election by a corporate United States shareholder to exclude from its gross income for the taxable year the subpart F income of a controlled foreign corporation, the earnings and profits of such foreign corporation for such year with respect to such shareholder must be determined, for purposes of this section, under the rules provided by §1.964–1, even though the amount of the minimum distribution required under §1.963–2(a) to be received by such shareholder from such earnings and profits of such foreign corporation, or from the consolidated earnings and profits of the chain or group which includes such foreign corporation, is zero. Effective for taxable years of foreign corporations beginning after December 31, 1975, section 963 is repealed by section 602(a)(1) of the Tax Reduction Act of 1975 (89 Stat. 58); accordingly, this paragraph (g)(2) is inapplicable with respect to computing earnings and profits for such taxable years.

(3) *Time and manner of making choice*. The controlling United States shareholders (as defined in §1.964–1(c)(5)) of a foreign corporation shall make the choice referred to in paragraph (g)(1) of this section (including the elections permitted by §1.964–1 (b) and (c)) by filing a written statement to such effect with the Director of the Internal Revenue Service Center, 11601 Roosevelt Boulevard, Philadelphia, Pennsylvania 19155, within 180 days after the close of the first taxable year of the foreign corporation during which such shareholders receive a distribution of earnings and profits with respect to which the benefits of this section are claimed or on or before November 15, 1965, whichever is later. For purposes of this paragraph (g)(3), the 180-day period shall commence on the date of receipt of any distribution which is considered paid from the accumulated profits of a preceding year or years under paragraph (g)(4) of this section. See §1.964–1(c)(3) (ii) and (iii) for procedures requiring notification of the Director of the Internal Revenue Service Center and noncontrolling shareholders of action taken.

(4) *Determination by district director*. The district director in whose district is filed the income tax return of the domestic shareholder claiming a credit under section 901 for foreign income taxes deemed, under section 902 and this section, to be paid by such shareholder shall have the power to determine, with respect to a foreign corporation, from the accumulated profits of what taxable year or years the dividends were paid. In making such determination the district director shall, unless it is otherwise established to his satisfaction, treat any dividends which are paid in the first 60 days of any taxable year of such a corporation as having been paid from the accumulated profits of the preceding taxable year or years of such corporation and shall, in other respects, treat any dividends as having been paid from the most recently accumulated profits. For purposes of this paragraph (g)(4), in the case of a foreign corporation the foreign income taxes of which are determined on the basis of an accounting period of less than 1 year, the term ''year'' shall mean such accounting period. See sections 441 (b)(3) and 443.

(h) *Source of income from first-tier corporation and country to which tax is deemed paid*—(1) *Source of income*. For purposes of section 904(a)(1) (relating to the per-country limitation), in the case of a dividend received by a domestic

shareholder from a first-tier corporation there shall be deemed to be derived from sources within the foreign country or possession of the United States under the laws of which the first-tier corporation is created or organized the sum of the amounts which under paragraph (a)(3)(ii) of § 1.861–3 are treated, with respect to such dividend, as income from sources without the United States.

(2) *Country to which taxes deemed paid.* For purposes of section 904, all foreign income taxes paid, or deemed under paragraph (c) of this section to be paid, by a first-tier corporation shall be deemed to be paid to the foreign country or possession of the United States under the laws of which such first-tier corporation is created or organized.

(i) *United Kingdom income taxes paid with respect to royalties.* A taxpayer shall not be deemed under section 902 and this section to have paid any taxes with respect to which a credit is allowable to such taxpayer or any other taxpayer by virtue of section 905(b).

(j) *Information to be furnished.* If the credit for foreign income taxes claimed under section 901 includes taxes deemed, under paragraph (b)(2) of this section, to be paid, the domestic shareholder must furnish the same information with respect to such taxes as it is required to furnish with respect to the taxes actually paid or accrued by it and for which credit is claimed. See § 1.905–2. For other information required to be furnished by the domestic shareholder for the annual accounting period of certain foreign corporations ending with or within such shareholder's taxable year, and for reduction in the amount of foreign income taxes paid or deemed to be paid for failure to furnish such information, see section 6038 and the regulations thereunder.

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

Example 1. Throughout 1978, domestic corporation M owns all the one class of stock of foreign corporation A. Both corporations use the calendar year as the taxable year. Corporation A has accumulated profits, pays foreign income taxes, and pays dividends for 1978 as summarized below. For 1978, M Corporation is deemed, under paragraph (b)(2) of this section, to have paid $20 of the foreign income taxes paid by A Corporation for 1978 and includes such amount in gross income under section 78 as a dividend, determined as follows:

Gains, profits, and income of A Corp.	$100
Foreign income taxes imposed on or with respect to gains, profits, and income	40
Accumulated profits	100
Foreign income taxes paid on or with respect to accumulated profits (total foreign income taxes)	40
Accumulated profits in excess of foreign income taxes	60
Dividends paid to M Corp	30
Foreign income taxes of A Corp. deemed paid by M Corp. under section 902(a) ($40 × $30/$60)	20

Example 2. The facts are the same as in example 1, except that M Corporation also owns all the one class of stock of foreign corporation B which also uses the calendar year as the taxable year. Corporation B has accumulated profits, pays foreign income taxes, and pays dividends for 1978 as summarized below. For 1978, M Corporation is deemed under paragraph (b)(2) of this section, to have paid $20 of the foreign income taxes paid by A Corporation for 1978 and to have paid $50 of the foreign income taxes paid by B Corporation for 1978, and includes $70 in gross income as a dividend under section 78, determined as follows:

B CORPORATION

Gains, profits and income	$200
Foreign income taxes imposed on or with respect to gains, profits, and income	100
Accumulated profits	200
Foreign income taxes paid by B Corp. on or with respect to accumulated profits	100
Accumulated profits in excess of foreign income taxes	100
Dividends paid to M Corp	50
Foreign income taxes of B Corporation deemed paid by M Corporation under section 902(a) ($100 × $50/$100)	50

M CORPORATION

Foreign income taxes deemed paid under section 902(a):.	
Taxes of A Corp. (from example 1)	$20
Taxes of B Corp. (as determined above)	50
Total	70
Foreign income taxes included in gross income under section 78 as a dividend:	
Taxes of A Corp. (from example 1)	20
Taxes of B Corp	50
Total	70

Example 3. For 1978, domestic corporation M owns all the one class of stock of foreign corporation A, which in turn owns all the one class of stock of foreign corporation B. All corporations use the calendar year as the taxable year. For 1978, M Corporation is deemed under paragraph (b)(2) of this section to have paid $50 of the foreign income taxes paid, or deemed under paragraph (c)(2) of this section to be paid, by A Corporation for such

year and includes such amount in gross income as a dividend under section 78, determined as follows upon the basis of the facts assumed:

B Corp. (second-tier corporation):	
Gains, profits, and income	$300
Foreign income taxes imposed on or with respect to gains, profits, and income	120
Accumulated profits	300
Foreign income taxes paid by B Corp. on or with respect to its accumulated profits (total foreign income taxes)	120
Accumulated profits in excess of foreign income taxes	180
Dividends paid on December 31, 1978 to A Corp.	90
Foreign income taxes of B Corp. deemed paid by A Corp. for 1978 under section 902(b)(1) ($120 × $90/$180)	60
A Corp. (first-tier corporation):	
Gains, profits, and income:	
Business operations	200
Dividends from B Corp.	90
Total	290
Foreign income taxes imposed on or with respect to gains, profits, and income	40
Accumulated profits	$290
Foreign income taxes paid by A Corp. on or with respect to its accumulated profits (total foreign income taxes)	40
Accumulated profits in excess of foreign income taxes	250
Foreign income taxes paid, and deemed to be paid, by A Corp. for 1978 on or with respect to its accumulated profits for such year ($60 + $40)	100
Dividends paid on Deember. 31, 1978, to M Corp.	125
M Corp. (domestic shareholder):	
Foreign income taxes of A Corp. deemed paid by M Corp. for 1978 under section 902(a) ($100 × $125/$250)	50
Foreign income taxes included in gross income of M Corp. under section 78 as a dividend received from A Corp.	50

Example 4. Throughout 1978, domestic corporation M owns 50 percent of the voting stock of foreign corporation A, not a less developed country corporation. A Corporation has owned 40 percent of the voting stock of foreign corporation B, since 1970; B Corporation has owned 30 percent of the voting stock of foreign corporation C, since 1972. B Corporation, uses a fiscal year ending on June 30 as its taxable year; all other corporations use the calendar year as the taxable year. On February 1, 1977, B Corporation receives a dividend from C Corporation out of C Corporation's accumulated profits for 1976. On February 15, 1977, A Corporation receives a dividend from B Corporation out of B Corporation's accumulated profits for its fiscal year ending in 1977. On February 15, 1978, M Corporation receives a dividend from A Corporation out of A Corporation's accumulated profits for 1977. For 1978, M Corporation is deemed under paragraph (b)(2) of this section to have paid $81.67 of the foreign income taxes paid, or deemed under paragraph (c)(2) of this section to be paid, by A Corporation on or with respect to its accumulated profits for 1977, and M Corporation includes that amount in gross income as a dividend under section 78, determined as follows upon the basis of the facts assumed:

C Corp. (third-tier corporation):	
Gains, profits, and income for 1976	$2,000.00
Foreign income taxes imposed on or with respect to such gains, profits, and income	800.00
Accumulated profits	2,000.00
Foreign income taxes paid by C Corp. on or with respect to its accumulated profits (total foreign income taxes)	800.00
Accumulated profits in excess of foreign income taxes	1,200.00
Dividends paid on Feb. 1, 1977 to B Corp	150.00
Foreign income taxes of C Corp. for 1976 deemed paid by B Corp. for its fiscal year ending in 1977 ($800 × $150/$1,200)	100.00
B Corp. (second-tier corporation):	
Gains, profits, and income for fiscal year ending in 1977:	
Business operations	850.00
Dividends from C Corp	150.00
Total	1,000.00
Foreign income taxes imposed on or with respect to gains, profits, and income	200.00
Accumulated profits	1,000.00
Foreign income taxes paid by B Corp. on or with respect to its accumulated profits (total foreign income taxes)	$200.00
Accumulated profits in excess of foreign income taxes	800.00
Foreign income taxes paid, and deemed to be paid, by B Corp. for its fiscal year on or with respect to its accumulated profits for such year ($100 + $200)	300.00
Dividends paid on February 15, 1977 to A Corp	120.00
Foreign income taxes of B Corp. for its fiscal year deemed paid by A Corp. for 1977 ($300 × $120/$800)	45.00
A Corp. (first-tier corporation):	
Gains, profits, and income for 1977:	
Business operations	380.00
Dividends from B Corp	120.00
Total	500.00
Foreign income taxes imposed on or with respect to gains, profits, and income	200.00
Accumulated profits	500.00
Foreign income taxes paid by A Corp. on or with respect to its accumulated profits (total foreign income taxes)	200.00
Accumulated profits in excess of foreign taxes	300.00
Foreign income taxes paid, and deemed to be paid, by A Corp. for 1977 on or with respect to its accumulated profits for such year ($45 + $200)	245.00
Dividends paid on Feb. 15, 1978 to M Corp	100.00
M Corp. (domestic shareholder):	
Foreign income taxes of A Corp. for 1977 deemed paid by M Corp. for 1978 under section 902(a)(1) ($245 × $100/$300)	81.67
Foreign income taxes included in gross income of M Corp. under section 78 as a dividend received from A Corp	81.67

(l) *Effective date*. Except as provided in § 1.902–4, this section applies to any distribution received from a first-tier corporation by its domestic shareholder after December 31, 1964, and before the beginning of the foreign corporation's first taxable year beginning

after December 31, 1986. If, however, the first day on which the ownership requirements of section 902(c)(3)(B) and § 1.902–1(a)(1) through (4) are met with respect to the foreign corporation is in a taxable year of the foreign corporation beginning after December 31, 1986, then this section shall apply to all taxable years beginning after December 31, 1964, and before the year in which the ownership requirements are first met. See § 1.902–1(a)(13)(i). For corresponding rules applicable to distributions received by the domestic shareholder prior to January 1, 1965, see § 1.902–5 as contained in the 26 CFR part 1 edition revised April 1, 1976.

[T.D. 7481, 42 FR 20125, Apr. 18, 1977, as amended by T.D. 7490, 42 FR 30497, June 15, 1977; T.D. 7649, 44 FR 60086, Oct. 18, 1979. Redesignated and amended by T.D. 8708, 62 FR 927, 940, Jan. 7, 1997; 62 FR 7155, Feb. 18, 1997]

§ 1.902–4 Rules for distributions attributable to accumulated profits for taxable years in which a first-tier corporation was a less developed country corporation.

(a) *In general*. If a domestic shareholder receives a distribution from a first-tier corporation before January 1, 1978, in a taxable year of the domestic shareholder beginning after December 31, 1964, which is attributable to accumulated profits of the first-tier corporation for a taxable year beginning before January 1, 1976, in which the first-tier corporation was a less developed country corporation (as defined in 26 CFR § 1.902–2 revised as of April 1, 1978), then the amount of the credit deemed paid by the domestic shareholder with respect to such distribution shall be calculated under the rules relating to less developed country corporations contained in (26 CFR § 1.902–1 revised as of April 1, 1978).

(b) *Combined distributions*. If a domestic shareholder receives a distribution before January 1, 1978, from a first-tier corporation, a portion of which is described in paragraph (a) of this section, and a portion of which is attributable to accumulated profits of the first-tier corporation for a year in which the first-tier corporation was not a less developed country corporation, then the amount of taxes deemed paid by the domestic shareholder shall be computed separately on each portion of the dividend. The taxes deemed paid on that portion of the dividend described in paragraph (a) shall be computed as specified in paragraph (a). The taxes deemed paid on that portion of the dividend described in this paragraph (b), shall be computed as specified in § 1.902–3.

(c) *Distributions of a first-tier corporation attributable to certain distributions from second- or third-tier corporations*. Paragraph (a) shall apply to a distribution received by a domestic shareholder before January 1, 1978, from a first-tier corporation out of accumulated profits for a taxable year beginning after December 31, 1975, if:

(1) The distribution is attributable to a distribution received by the first-tier corporation from a second- or third-tier corporation in a taxable year beginning after December 31, 1975.

(2) The distribution from the second- or third-tier corporation is made out of accumulated profits of the second- or third-tier corporation for a taxable year beginning before January 1, 1976, and

(3) The first-tier corporation would have qualified as a less developed country corporation under section 902(d) (as in effect on December 31, 1975), in the taxable year in which it received the distribution.

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

Example 1. M, a domestic corporation owns all of the one class of stock of foreign corporation A. Both corporations use the calendar year as the taxable year. A Corporation pays a dividend to M Corporation on January 1, 1977, partly out of its accumulated profits for calendar year 1976 and partly out of its accumulated profits for calendar year 1975. For 1975 A Corporation qualified as a less developed country corporation under the former section 902(d) (as in effect on December 31, 1975). M Corporation is deemed under paragraphs (a) and (b) of this section to have paid $63 of foreign income taxes paid by A Corporation on or with respect to its accumulated profits for 1976 and 1975 and M Corporation includes $36 of that amount in gross income as a dividend under section 78, determined as follows upon the basis of the facts assumed:

1976	
Gains, profits, and income of A Corp. for 1976	$120.00
Foreign income taxes imposed on or with respect to such gains, profits, and income	36.00

1976—Continued

Accumulated profits	120.00
Foreign income taxes paid by A Corp. on or with respect to its accumulated profits (total foreign income taxes)	36.00
Accumulated profits in excess of foreign income taxes	84.00
Dividend to M Corp. out of 1976 accumulated profits	84.00
Foreign income taxes of A for 1976 deemed paid by M Corp. ($84/$84 × $36)	36.00
Foreign income taxes included in gross income of M Corp. under section 78 as a dividend from A Corp	36.00

1975

Gains, profits, and income of A Corp. for 1975	$257.14
Foreign income taxes imposed on or with respect to such gains, profits, and income	77.14
Accumulated profits (under section 902(c)(1)(B) as in effect prior to amendment by the Tax Reform Act of 1976)	180.00
Foreign income taxes paid by A Corp. on or with respect to its accumulated profits ($77.14 × $180/$257.14)	54.00
Dividend to M Corp. out of accumulated profits of A Corp. for 1975	90.00
Foreign income taxes of A Corp. for 1975 deemed paid by M Corp. (under section 902(a)(2) as in effect prior to amendment by the Tax Reform Act of 1976) ($54 × $90/$180)	27.00
Foreign income taxes included in gross income of M Corp. under section 78 as a dividend from A Corp	0

Example 2. The facts are the same as in example 1, except that the distribution from A Corporation to M Corporation on January 1, 1977, was from accumulated profits of A Corporation for 1976. A Corporation's accumulated profits for 1976 were made up of income from its trade or business, and a dividend paid by B, a second-tier corporation in 1976. The dividend from B Corporation to A Corporation was from accumulated profits of B Corporation for 1975. A Corporation would have qualified as a less developed country corporation for 1976 under the former section 902(d) (as in effect on December 31, 1975). M Corporation is deemed under paragraphs (b) and (c) of this section to have paid $543 of the foreign taxes paid or deemed paid by A Corporation on or with respect to its accumulated profits for 1976, and M Corporation includes $360 of that amount in gross income as a dividend under section 78, determined as follows upon the basis of the facts assumed:

Total gains, profits, and income of A Corp. for 1976	$1,500
Gains and profits from business operations	1,200
Gains and profits from dividend A Corp. received in 1976 from B Corp. out of accumulated profits of B Corp. for 1975	300
Foreign taxes imposed on or with respect to such profits and income	450
Foreign taxes paid by A Corp. attributable to gains and profits from A Corp.'s business operations	360
Foreign taxes paid by A Corp. attributable to dividend from B Corp. in 1976	90
Dividends from A Corp. to M Corp. on Jan. 1, 1977	1,050
Portion of dividend attributable to gains and profits of A Corp. from business operations. ($1,200/$1,500 × $1,050)	840
Portion of dividends attributable to gains on profits of A Corp. from dividend from B Corp. ($300/$1,500 × $1,050)	210

(a) *Amount of foreign taxes of A Corp. deemed paid by M Corp. on A Corp.'s gains and profits for 1976 from business operations.*

Gains, profits, and income of A Corp. from business operations	$1,200
Foreign income taxes imposed on or with respect to gains, profits, and income	360
Accumulated profits	1,200
Foreign income taxes paid by A Corp. on or with respect to its accumulated profits (total foreign income taxes)	360
Accumulated profits in excess of foreign income taxes	840
Dividend to M Corp	840
Foreign taxes of A Corp. deemed paid by M Corp. ($360 × $840/$840)	360
Foreign taxes included in gross income of M Corp. under section 78 as a dividend	360

(b) *Amount of foreign taxes of A Corp. deemed paid by M Corp. on portion of the dividend attributable to B Corp.'s accumulated profits for 1975.*

B Corp. (second-tier corporation):	
Gains, profits, and income for calendar year 1975	$1,000
Foreign income taxes imposed on or with respect to gains, profits, and income	400
Accumulated profits (under section 902(c)(1)(B) as in effect prior to amendment by the Tax Reform Act of 1976)	600
Foreign income taxes paid by B Corp. on or with respect to its accumulated profits ($400 × $600/$1,000)	240
Dividend to A Corp. in 1976	300
Foreign taxes of B Corp. for 1975 deemed paid by A Corp. (under section 902(b)(1)(B) as in effect prior to amendment by the Tax Reform Act of 1976) ($240 × $300/$600)	120
A Corp. (first-tier corporation):	
Gains, profits, and income for 1976 attributable to dividend from B Corp.'s accumulated profits for 1975	300
Foreign income taxes imposed on or with respect to such gains, profits, and income	90
Accumulated profits (under section 902(c)(1)(B) as in effect prior to amendment by the Tax Reform Act of 1976)	210
Foreign taxes paid by A Corp. on or with respect to such accumulated profits ($90 × $210/$300)	63
Foreign income taxes paid and deemed to be paid by A Corp. for 1976 on or with respect to such accumulated profits ($120 + $63)	183
Dividend paid to M Corp. attributable to dividend from B Corp. out of accumulated profits for 1975)	210
Foreign taxes of A Corp. deemed paid by M Corp. (under section 902(a)(2) as in effect prior to amendment by the Tax Reform Act of 1976) ($183 × $210/$210)	183
Amount included in gross income of M Corp. under section 78	0

[T.D. 7649, 44 FR 60087, Oct. 18, 1979. Redesignated and amended by T.D. 8708, 62 FR 927, 940, Jan. 7, 1997]

§ 1.903–1 Taxes in lieu of income taxes.

(a) *In general.* Section 903 provides that the term ''income, war profits, and excess profits taxes'' shall include a tax paid in lieu of a tax on income, war profits, or excess profits (''income tax'') otherwise generally imposed by any foreign country. For purposes of this section and §§ 1.901–2 and 1.901–2A, such a tax is referred to as a ''tax in lieu of an income tax''; and the terms ''paid'' and ''foreign country'' are defined in § 1.901–2(g). A foreign levy (within the meaning of § 1.901–2(g)(3)) is a tax in lieu of an income tax if and only if—

(1) It is a tax within the meaning of § 1.901–2(a)(2); and

(2) It meets the substitution requirement as set forth in paragraph (b) of this section.

The foreign country's purpose in imposing the foreign tax (*e.g.*, whether it imposes the foreign tax because of administrative difficulty in determining the base of the income tax otherwise generally imposed) is immaterial. It is also immaterial whether the base of the foreign tax bears any relation to realized net income. The base of the tax may, for example, be gross income, gross receipts or sales, or the number of units produced or exported. Determinations of the amount of a tax in lieu of an income tax that is paid by a person and determinations of the person by whom such tax is paid are made under § 1.901–2 (e) and (f), respectively, substituting the phrase ''tax in lieu of an income tax'' for the phrase ''income tax'' wherever the latter appears in those sections. Section 1.901–2A contains additional rules applicable to dual capacity taxpayers (as defined in § 1.901–2(a)(2)(ii) (A)). The rules of this section are applied independently to each separate levy (within the meaning of §§ 1.901–2(d) and 1.901–2A (a)) imposed by the foreign country. Except as otherwise provided in paragraph (b)(2) of this section, a foreign tax either is or is not a tax in lieu of an income tax in its entirety for all persons subject to the tax.

(b) *Substitution*—(1) *In general.* A foreign tax satisfies the substitution requirement if the tax in fact operates as a tax imposed in substitution for, and not in addition to, an income tax or a series of income taxes otherwise generally imposed. However, not all income derived by persons subject to the foreign tax need be exempt from the income tax. If, for example, a taxpayer is subject to a generally imposed income tax except that, pursuant to an agreement with the foreign country, the taxpayer's income from insurance is subject to a gross receipts tax and not to the income tax, then the gross receipts tax meets the substitution requirement notwithstanding the fact that the taxpayer's income from other activities, such as the operation of a hotel, is subject to the generally imposed income tax. A comparison between the tax burden of this insurance gross receipts tax and the tax burden that would have obtained under the generally imposed income tax is irrelevant to this determination.

(2) *Soak-up taxes.* A foreign tax satisfies the substitution requirement only to the extent that liability for the foreign tax is not dependent (by its terms or otherwise) on the availability of a credit for the foreign tax against income tax liability to another country. If, without regard to this paragraph (b)(2), a foreign tax satisfies the requirement of paragraph (b)(1) of this section (including for this purpose any foreign tax that both satisfies such requirement and also is an income tax within the meaning of § 1.901–2(a)(1)), liability for the foreign tax is dependent on the availability of a credit for the foreign tax against income tax liability to another country only to the extent of the lesser of—

(i) The amount of foreign tax that would not be imposed on the taxpayer but for the availability of such a credit to the taxpayer (within the meaning of § 1.901–2(c)), or

(ii) The amount, if any, by which the foreign tax paid by the taxpayer exceeds the amount of foreign income tax that would have been paid by the taxpayer if it had instead been subject to the generally imposed income tax of the foreign country.

(3) *Examples*. The provisions of this paragraph (b) may be illustrated by the following examples:

Example 1. Country X has a tax on realized net income that is generally imposed except that nonresidents are not subject to that tax. Nonresidents are subject to a gross income tax on income from country X that is not attributable to a trade or business carried on in country X. The gross income tax imposed on nonresidents satisfies the substitution requirement set forth in this paragraph (b). See also examples 1 and 2 of § 1.901–2(b)(4)(iv).

Example 2. The facts are the same as in example 1, with the additional fact that payors located in country X are required by country X law to withhold the gross income tax from payments they make to nonresidents, and to remit such withheld tax to the government of country X. The result is the same as in example 1.

Example 3. The facts are the same as in example 2, with the additional fact that the gross income tax on nonresidents applies to payments for technical services performed by them outside of country X. The result is the same as in example 2.

Example 4. Country X has a tax that is generally imposed on the realized net income of nonresident corporations that is attributable to a trade or business carried on in country X. The tax applies to all nonresident corporations that engage in business in country X except for such corporations that engage in contracting activities, each of which is instead subject to two different taxes. The taxes applicable to nonresident corporations that engage in contracting activities satisfy the substitution requirement set forth in this paragraph (b).

Example 5. Country X imposes both an excise tax and an income tax. The excise tax, which is payable independently of the income tax,is allowed as a credit against the income tax. For 1984 *A* has a tentative income tax liability of 100u (units of country X currency) but is allowed a credit for 30u of excise tax that it has paid. Pursuant to paragraph (e)(4)(i) of § 1.901–2, the amount of excise tax *A* has paid to country X is 30u and the amount of income tax *A* has paid to country X is 70u. The excise tax paid by *A* does not satisfy the substitution requirement set forth in this paragraph (b) because the excise tax is imposed on *A* in addition to, and not in substitution for, the generally imposed income tax.

Example 6. Pursuant to a contract with country X, *A*, a domestic corporation engaged in manufacturing activities in country X, must pay tax to country X equal to the greater of (i) 5u (units of country X currency) per item produced, or (ii) the maximum amount creditable by *A* against its U.S. income tax liability for that year with respect to income from its country X operations. Also pursuant to the contract, *A* is exempted from country X's otherwise generally imposed income tax. *A* produces 16 items in 1984 and the maximum amount creditable by *A* against its U.S. income tax liability for 1984 is 125u. If *A* had been subject to country X's otherwise generally imposed income tax it would have paid a tax of 150u. Pursuant to paragraph (b)(2) of this section, the amount of tax paid by *A* that is dependent on the availability of a credit against income tax of another country is 0 (lesser of (i) 45u, the amount that would not be imposed but for the availability of a credit (125u–80u), or (ii) 0, the amount by which the contractual tax (125u) exceeds the generally imposed income tax (150u)).

Example 7. The facts are the same as in example 6 except that, of the 150u *A* would have paid if it had been subject to the otherwise generally imposed income tax, 60u is dependent on the availability of a credit against income tax of another country. The amount of tax actually paid by *A* (*i.e.*, 125u) that is dependent on the availability of a credit against income tax of another country is 35u (lesser of (i) 45u, computed as in example , § 6, or (ii) 35u, the amount by which the contractual tax (125u) exceeds the amount *A* would have paid as income tax if it had been subject to the otherwise generally imposed income tax (90u, *i.e.*, 150u–60u).

(c) *Effective date*. The effective date of this section is as provided in § 1.901–2(h).

[T.D. 7918, 48 FR 46295, Oct. 12, 1983; 48 FR 52033, Nov. 16, 1983]

§ 1.904–0 Outline of regulation provisions for section 904.

This section lists the headings for §§ 1.904–1 through 1.904–7.

§ 1.904–1 Limitation on credit for foreign taxes.

(a) Per-country limitation.
(1) General.
(2) Illustration of principles.
(b) Overall limitation.
(1) General.
(2) Illustration of principles.
(c) Special computation of taxable income.
(d) Election of overall limitation.
(1) In general.
(i) Manner of making election.
(ii) Revocation for first taxable year beginning after December 31, 1969.
(2) Method of making the initial election.
(3) Method of revoking an election and making a new election.
(e) Joint return.
(1) General.
(2) Electing the overall limitation.

§ 1.904–2 Carryback and carryover of unused foreign tax.

(a) Credit for foreign tax carryback or carryover.
(b) Years to which carried.
(1) General.
(2) Definitions.
(3) Taxable years beginning before January 1, 1958.
(c) Tax deemed paid or accrued.
(1) Unused foreign tax for per-country limitation year.
(2) Unused foreign tax for overall limitation year.
(3) Unused foreign tax with respect to foreign mineral income.
(d) Determination of excess limitation for certain years.
(e) Periods of less than 12 months.
(f) Statement with tax return.
(g) Illustration of carrybacks and carryovers.
(h) Transition rules for carryovers and carrybacks of pre-2003 and post-2002 unused foreign tax paid or accrued with respect to dividends from noncontrolled section 902 corporations.
(1) Carryover of unused foreign tax.
(2) Carryback of unused foreign tax.
(i) Transition rules for carryovers and carrybacks of pre-2007 and post-2006 unused foreign tax.
(1) Carryover of unused foreign tax.
(i) General rule.
(ii) Safe harbor.
(2) Carryback of unused foreign tax.
(i) General rule.
(ii) Safe harbor.
(3) Effective/applicability date.

§ 1.904–3 Carryback and carryover of unused foreign tax by husband and wife.

(a) In general.
(b) Joint unused foreign tax and joint excess limitation.
(c) Continuous use of joint return.
(d) From separate to joint return.
(e) Amounts carried from or through a joint return year to or through a separate return year.
(f) Allocation of unused foreign tax and excess limitation.
(1) Limitation.
(i) Per-country limitation.
(ii) Overall limitation.
(2) Unused foreign tax.
(i) Per-country limitation.
(ii) Overall limitation.
(3) Excess limitation.
(i) Per-country limitation taxpayer.
(ii) Overall limitation.
(4) Excess limitation to be applied.
(5) Reduction of excess limitation.
(6) Spouses using different limitations.
(g) Illustrations.

§ 1.904–4 Separate application of section 904 with respect to certain categories of income.

(a) In general.
(b) Passive category income.
(1) In general.
(2) Passive income.
(i) In general.
(ii) Exceptions.
(iii) Active rents or royalties.
(A) In general.
(B) Active conduct of trade or business.
(iv) Examples.
(3) Specified passive category income.
(c) High-taxed income.
(1) In general.
(2) Grouping of items of income in order to determine whether passive income is high-taxed income.
(i) Effective dates.
(A) In general.
(B) Application to prior periods.
(ii) Grouping rules.
(A) Initial allocation and apportionment of deductions and taxes.
(B) Reallocation of loss groups.
(3) Amounts received or accrued by United States persons.
(4) Dividends and inclusions from controlled foreign corporations, dividends from noncontrolled section 902 corporations, and income of foreign QBUs.
(5) Special rules.
(i) Certain rents and royalties.
(ii) Treatment of partnership income.
(iii) Currency gain or loss.
(iv) Coordination with section 954(b)(4).
(6) Application of this paragraph to additional taxes paid or deemed paid in the year of receipt of previously taxed income.
(i) Determination made in year of inclusion.
(ii) Exception.
(iii) Allocation of foreign taxes imposed on distributions of previously taxed income.
(iv) Increase in taxes paid by successors.
(A) General rule.
(B) Exception for U.S. shareholders not entitled to look-through.
(7) Application of this paragraph to certain reductions of tax on distributions of income.
(i) In general.
(ii) Allocation of reductions of foreign tax.
(iii) Interaction with section 954(b)(4).
(8) Examples.
(d) [Reserved]
(e) Financial services income.
(1) In general.
(2) Active financing income.
(i) Income included.
(3) Financial services entities.
(i) In general.
(ii) Special rule for affiliated groups.
(iii) Treatment of partnerships and other pass-through entities.
(A) Rule.
(B) Examples.

(iv) Examples.
(4) Definition of incidental income.
(i) In general.
(A) Rule.
(B) Examples.
(ii) Income that is not incidental income.
(5) Exceptions.
(f)–(g) [Reserved]
(h) Export financing interest.
(1) Definitions.
(i) Export financing.
(ii) Fair market value.
(iii) Related person.
(2) Treatment of export financing interest.
(3) Exception.
(4) Examples.
(5) Income eligible for section 864(d)(7) exception (same country exception) from related person factoring treatment.
(i) Income other than interest.
(ii) Interest income.
(iii) Examples.
(i) Interaction of section 907(c) and income described in this section.
(j) Special rule for certain currency gains and losses.
(k) Special rule for alternative minimum tax foreign tax credit.
(l) Priority rule.
(m) Income treated as allocable to an additional separate category.

§ 1.904–5 Look-through rules as applied to controlled foreign corporations and other entities.

(a) Definitions.
(b) In general.
(c) Rules for specific types of inclusions and payments.
(1) Subpart F inclusions.
(i) Rule.
(ii) Examples.
(2) Interest.
(i) In general.
(ii) Allocating and apportioning expenses including interest paid to a related person.
(iii) Allocating and apportioning expenses of a noncontrolled section 902 corporation.
(iv) Definitions.
(A) Value of assets and reduction in value of assets and gross income.
(B) Related person debt allocated to passive assets.
(v) Examples.
(3) Rents and royalties.
(4) Dividends.
(i) Look-through rule for controlled foreign corporations.
(ii) Special rule for dividends attributable to certain loans.
(iii) Look-through rule for noncontrolled section 902 corporations.
(iv) Examples.
(d) Effect of exclusions from Subpart F income.
(1) De minimis amount of Subpart F income.
(2) Exception for certain income subject to high foreign tax.
(3) Examples.
(e) Treatment of Subpart F income in excess of 70 percent of gross income.
(1) Rule.
(2) Example.
(f) Modifications of look-through rules for certain income.
(1) High withholding tax interest.
(i) Rule.
(ii) Example.
(2) Distributions from a FSC.
(3) Example.
(g) Application of the look-through rules to certain domestic corporations.
(h) Application of the look-through rules to partnerships and other pass-through entities.
(1) General rule.
(2) Exception for certain partnership interests.
(i) Rule.
(ii) Exceptions.
(3) Income from the sale of a partnership interest.
(i) In general.
(ii) Exception for sale by 25-percent owner.
(4) Value of a partnership interest.
(i) Application of look-through rules to related entities.
(1) In general.
(2) Exception for distributive shares of partnership income.
(3) Special rule for dividends between controlled foreign corporations.
(4) Payor and recipient of dividend are members of the same qualified group.
(5) Examples.
(j) Look-through rules applied to passive foreign investment company inclusions.
(k) Ordering rules.
(1) In general.
(2) Specific rules.
(l) Examples.
(m) Application of section 904(h).
(1) In general.
(2) Treatment of interest payments.
(i) Interest payments from controlled foreign corporations.
(ii) Interest payments from noncontrolled section 902 corporations.
(3) Examples.
(4) Treatment of dividend payments.
(i) Rule.
(ii) Determination of earnings and profits from United States sources.
(iii) Example.
(5) *Treatment of inclusions under sections 951(a)(1)(A) and 1293.*
(i) Rule.
(ii) Example.
(6) Treatment of section 78 amount.
(7) Coordination with treaties.
(i) Rule.
(ii) Example.

(n) Order of application of sections 904(d) and (h).

(o) Effective date.

(1) Rules for controlled foreign corporations and other look-through entities.

(2) Rules for noncontrolled section 902 corporations.

(3) Rules for income from the sale of a partnership interest.

§ 1.904–6 Allocation and apportionment of taxes.

(a) Allocation and apportionment of taxes to a separate category or categories of income.

(1) Allocation of taxes to a separate category or categories of income.

(i) Taxes related to a separate category of income.

(ii) Apportionment of taxes related to more than one separate category.

(iii) Apportionment of taxes for purposes of applying the high tax income test.

(iv) Special rule for base and timing differences.

(2) Reserved.

(b) Application of paragraph (a) to sections 902 and 960.

(1) Determination of foreign taxes deemed paid.

(2) Distributions received from foreign corporations that are excluded from gross income under section 959(b).

(3) Application of section 78.

(4) Increase in limitation.

(c) Examples.

§ 1.904–7 Transition rules.

(a) Characterization of distributions and section 951(a)(1)(A) (ii) and (iii) and (B) inclusions of earnings of a controlled foreign corporation accumulated in taxable years beginning before January 1, 1987, during taxable years of both the payor controlled foreign corporation and the recipient which begin after December 31, 1986.

(1) Distributions and section 951(a)(1)(A) (ii) and (iii) and (B) inclusions.

(2) Limitation on establishing the character of earnings and profits.

(b) Application of look-through rules to distributions (including deemed distributions) and payments by an entity to a recipient when one's taxable year begins before January 1, 1987 and the other's taxable year begins after December 31, 1986.

(1) In general.

(2) Payor of interest, rents, or royalties is subject to the Act and recipient is not subject to the Act.

(3) Recipient of interest, rents, or royalties is subject to the Act and payor is not subject to the Act.

(4) Recipient of dividends and subpart F inclusions is subject to the Act and payor is not subject to the Act.

(5) Examples.

(c) Installment sales.

(d) Special effective date for high withholding tax interest earned by persons with respect to qualified loans described in section 1201(e)(2) of the Act.

(e) Treatment of certain recapture income.

(f) Treatment of non-look-through pools of a noncontrolled section 902 corporation or a controlled foreign corporation in post-2002 taxable years.

(1) Definition of non-look-through pools.

(2) Treatment of non-look-through pools of a noncontrolled section 902 corporation.

(3) Treatment of non-look-through pools of a controlled foreign corporation.

(4) Substantiation of look-through character of undistributed earnings and taxes in a non-look-through pool.

(i) Reconstruction of earnings and taxes pools.

(ii) Safe harbor method.

(iii) Inadequate substantiation.

(iv) Examples.

(5) Treatment of a deficit accumulated in a non-look-through pool.

(6) Treatment of pre-1987 accumulated profits.

(7) Treatment of post-1986 undistributed earnings or a deficit of a controlled foreign corporation attributable to dividends from a noncontrolled section 902 corporation paid in taxable years beginning before January 1, 2003.

(i) Look-through treatment of post-1986 undistributed earnings at controlled foreign corporation level.

(ii) Look-through treatment of deficit in post-1986 undistributed earnings at controlled foreign corporation level.

(iii) Substantiation required for look-through treatment.

(8) Treatment of distributions received by an upper-tier corporation from a lower-tier noncontrolled section 902 corporation, including when the corporations do not have the same taxable years.

(i) Rule.

(ii) Example.

(9) Election to apply pre-AJCA rules to 2003 and 2004 taxable years.

(i) Definition.

(ii) Time, manner, and form of election.

(iii) Treatment of non-look-through pools in taxable years beginning after December 31, 2004.

(iv) Carryover of unused foreign tax.

(v) Carryback of unused foreign tax.

(vi) Recapture of overall foreign loss or separate limitation loss in the single category for dividends from all noncontrolled section 902 corporations.

(vii) Recapture of separate limitation losses in other separate categories.

(viii) Treatment of undistributed earnings in an upper-tier corporation-level single category for dividends from lower-tier noncontrolled section 902 corporations.

(ix) Treatment of a deficit in the single category for dividends from lower-tier noncontrolled section 902 corporations.

(10) Effective/applicability date.

(g) Treatment of earnings and foreign taxes of a controlled foreign corporation or a noncontrolled section 902 corporation accumulated in taxable years beginning before January 1, 2007.

(1) Definitions.

(i) Pre-2007 pools.

(ii) Pre-2007 separate categories.

(iii) Post-2006 separate categories.

(2) Treatment of pre-2007 pools of a controlled foreign corporation or a noncontrolled section 902 corporation.

(3) Substantiation of post-2006 character of earnings and taxes in a pre-2007 pool.

(i) Reconstruction of earnings and taxes pools.

(ii) Safe harbor method.

(A) In general.

(B) General safe harbor method.

(C) Interest apportionment safe harbor.

(iii) Consistency rule.

(4) Treatment of pre-1987 accumulated profits.

(5) Treatment of earnings and foreign taxes in pre-2007 pools of a lower-tier controlled foreign corporation or noncontrolled section 902 corporation.

(6) Effective/applicability date.

[T.D. 8412, 57 FR 20642, May 14, 1992, as amended by T.D. 8627, 60 FR 56119, Nov. 7, 1995; T.D. 8805, 64 FR 1515, Jan. 11, 1999; T.D. 8916, 66 FR 274, Jan. 3, 2001; T.D. 9141, 69 FR 43306, July 20, 2004; T.D. 9260, 71 FR 24528, Apr. 25, 2006; 71 FR 77265, Dec. 26, 2006; T.D. 9368, 72 FR 72587, 72596, Dec. 21, 2007; T.D. 9452, 74 FR 27876, June 11, 2009; T.D. 9521, 76 FR 19269, Apr. 7, 2011]

§ 1.904–1 Limitation on credit for foreign taxes.

(a) *Per-country limitation*—(1) *General.* In the case of any taxpayer who does not elect the overall limitation under section 904(a)(2), the amount allowable as a credit for income or profits taxes paid or accrued to a foreign country or a possession of the United States is subject to the per-country limitation prescribed in section 904(a)(1). Such limitation provides that the credit for such taxes paid or accrued (including those deemed to have been paid or accrued other than by reason of section 904(d)) to each foreign country or possession of the United States shall not exceed that proportion of the tax against which credit is taken which the taxpayer's taxable income from sources within such country or possession (but not in excess of the taxpayer's entire taxable income) bears to his entire taxable income for the same taxable year. For special rules regarding the application of the per-country limitation when the taxpayer has derived section 904(f) interest or section 904(f) dividends, see § 1.904–4 or § 1.904–5.

(2) *Illustration of principles.* The operation of the per-country limitation under section 904(a)(1) on the credit for foreign taxes paid or accrued may be illustrated by the following examples:

Example 1. The credit for foreign taxes allowable for 1954 in the case of X, an unmarried citizen of the United States who in 1954 received the income shown below and had three exemptions under section 151, is $14,904, computed as follows:

Taxable income (computed without deductions for personal exemptions) from sources within the United States	$50,000
Taxable income (computed without deductions for personal exemptions) from sources within Great Britain	25,000
Total taxable income	75,000
United States income tax (based on taxable income computed with the deductions for personal exemptions)	44,712
British income and profits taxes	18,000
Per-country limitation (25,000/75,000 of $44,712)	14,904
Credit for British income and profits taxes (total British income and profits taxes, reduced in accordance with the per-country limitation)	14,904

Example 2. Assume the same facts as in example 1, except that the sources of X's income and taxes paid are as shown below. The credit for foreign taxes allowable to X is $13,442.40, computed as follows:

Taxable income (computed without deductions for personal exemptions) from sources within the United States	$50,000
Taxable income (computed without deductions for personal exemptions) from sources within Great Britain	15,000
Taxable income (computed without deductions for personal exemptions) from sources within Canada	10,000
Total taxable income	75,000
United States income tax (based on taxable income computed with the deductions for personal exemptions)	44,712
British income and profits taxes	10,800
Per-country limitation on British income and profits taxes (15,000/75,000 of $44,712)	8,942.40
Credit for British income and profits taxes as limited by per-country limitation	8,942.40
Canadian income and profits taxes	4,500.00
Per-country limitation on Canadian income and profits taxes (10,000/75,000 of $44,712)	5,961.60

Credit for Canadian income and profits taxes (total Canadian income and profits taxes, since such amount does not exceed the per-country limitation)		4,500.00
Total amount of credit allowable (sum of credits—$8,942.40 plus $4,500)		18,442.40

Example 3. A domestic corporation realized taxable income in 1954 in the amount of $100,000, consisting of $50,000 from United States sources and dividends of $50,000 from a Brazilian corporation, more than 10 percent of whose voting stock it owned. The Brazilian corporation paid income and profits taxes to Brazil on its income and in addition paid a dividend tax for the account of its shareholders on income distributed to them, the latter tax being withheld and paid at the source. The domestic corporation's credit for foreign taxes is $23,250, computed as follows:

Taxable income from sources within the United States		$50,000
Taxable income from sources within Brazil		50,000
Total taxable income		100,000
United States income tax		46,500
Dividend tax paid at source to Brazil		19,000
Income and profits taxes deemed under section 902 to have been paid to Brazil, computed as follows:		
Dividends received from Brazilian corporation during 1954		50,000
Income of Brazilian corporation during 1954		200,000
Income and profits taxes paid to Brazil on $200,000		30,000
Accumulated profits ($200,000 minus $30,000)		170,000
Brazilian taxes applicable to accumulated profits distributed: 50,000/170,000 of 170,000/200,000 of $30,000		7,500
Total income and profits taxes paid and deemed to have been paid to Brazil	26,500	
Per-country limitation (50,000/100,000 of $46,500)		23,250
Credit for Brazilian income and profits taxes as limited by per-country limitation		23,250

(b) *Overall limitation*—(1) *General.* In the case of any taxpayer who elects the overall limitation provided by section 904(a)(2), the total credit for taxes paid or accrued (including those deemed to have been paid or accrued other than by reason of section 904(d)) shall not exceed that proportion of the tax against which such credit is taken which the taxpayer's taxable income from sources without the United States (but not in excess of the taxpayer's entire taxable income) bears to his entire taxable income for the same taxable year. For special rules regarding the application of the overall limitation when the taxpayer has derived section 904(f) interest or section 904(f) dividends, see § 1.904–4 or § 1.904–5.

(2) *Illustration of principles.* The operation of the overall limitation under section 904(a)(2) may be illustrated by the following example:

Example. Corporation X, a domestic corporation, for its taxable year beginning January 1, 1961, elects the overall limitation provided by section 904(a)(2). For taxable year 1961 corporation X has taxable income of $275,000 of which $200,000 is from sources without the United States. The United States income tax is $137,500. During the taxable year corporation X pays or accrues to foreign countries $105,000 in income and profits taxes, consisting of $45,000 paid or accrued to foreign country Y and $60,000 to foreign country Z. The credit for such foreign taxes is limited to $100,000, i.e., 200,000 ÷ 275,000 × $137,500. The limitation would be the same whether or not some portion of the $200,000 of the taxable income from sources without the United States is from sources on the high seas or in a foreign country (other than Y and Z) which imposed no taxes allowable as a credit.

(c) *Special computation of taxable income.* For purposes of computing the limitations under paragraphs (a) and (b) of this section, the taxable income in the case of an individual, estate, or trust shall be computed without any deduction for personal exemptions under section 151 or 642(b).

(d) *Election of overall limitation*—(1) *In general*—(i) *Manner of making election.* The initial election under section 904(b) of the overall limitation provided by section 904(a)(2) may be made by the taxpayer for any taxable year beginning after December 31, 1960, without securing the consent of the Commissioner. The taxpayer may, for the first taxable year for which the election is to be made, make such election at any time before the expiration of the period referred to in paragraph (d) of § 1.901–1 for choosing the benefits of section 901 for such taxable year. Having made the initial election, the taxpayer may, within the time prescribed for making such election for such taxable year, revoke such election without the consent of the Commissioner. If such revocation is timely and properly made, the taxpayer may make his initial election of the overall limitation for a later taxable year without the consent of the Commissioner. If,

however, the taxpayer makes the initial election for a taxable year and the period prescribed for making such election for such taxable year expires, the taxpayer must continue the election of the overall limitation for all subsequent taxable years (whether or not foreign taxes were paid or accrued for any such year and notwithstanding that a deduction for foreign taxes under section 164 was claimed for any such year) until revoked with the consent of the Commissioner. See section 904(b)(1). If the election for any taxable year is revoked with the consent of the Commissioner, the taxpayer may not make a new election for such taxable year or for any subsequent taxable year without the consent of the Commissioner. If the election of the overall limitation is revoked for a taxable year, the per-country limitation shall apply to such taxable year and to all taxable years thereafter unless a new election of the overall limitation is made, either with or without the consent of the Commissioner in accordance with this section.

(ii) *Revocation for first taxable year beginning after December 31, 1969.* Notwithstanding subdivision (i) of this subparagraph, if the taxpayer has made an initial election under section 904(b) of the overall limitation for a taxable year beginning before January 1, 1970, and the period prescribed for making such election for such taxable year has expired, or if he has made a new election for such a taxable year with the consent of the Commissioner, he may revoke such election effective with respect to his first taxable year beginning after December 31, 1969, without the consent of the Commissioner. Such revocation may be made within the time prescribed for making an initial election for such first taxable year beginning after December 31, 1969. If such revocation is timely and properly made, the taxpayer may make a new election of the overall limitation for a later taxable year without the consent of the Commissioner. Such new election for a later taxable year may be made at any time before the expiration of the period referred to in paragraph (d) of § 1.901–1 for choosing the benefits of section 901 for such taxable year. The revocation of an election, or the making of a new election, pursuant to this subdivision shall be made in the same manner provided in subparagraph (2) of this paragraph for revoking or making an initial election. This subdivision applies even though the taxpayer is not required under section 901(e) and § 1.901–3 to reduce the amount of any foreign taxes paid, accrued, or deemed to be paid with respect to foreign mineral income for any taxable year beginning after December 31, 1969.

(2) *Method of making the initial election.* The initial election of the overall limitation under section 904(b) shall be made on Form 1116 in the case of an individual or on Form 1118 in the case of a corporation. The form shall be attached to the appropriate income tax return for the taxable year to which such election applies. Such election may be made, however, only for a taxable year for which the taxpayer chooses to claim a credit under section 901. If the taxpayer revokes the initial election without the consent of the Commissioner, he must file amended Form 1116 or 1118 and amended income tax returns or claims for refund, where applicable, for the taxable years to which the revocation applies. For rules relating to the filing of such forms, see paragraph (a) of § 1.905–2.

(3) *Method of revoking an election and making a new election.* A request to revoke an election of the overall limitation under section 904(b) when such revocation requires the consent of the Commissioner, or to make a new election when such election requires the consent of the Commissioner, shall be in writing and shall be addressed to the Commissioner of Internal Revenue, Washington, D.C. 20224. The request shall include the name and address of the taxpayer and shall be signed by the taxpayer or his duly authorized representative. It must specify the taxable year for which the revocation or new election is to be effective and shall be mailed within 75 days after the close of the first taxable year for which it is desired to make the change. It must be accompanied by a statement specifying the nature of the taxpayer's business, the countries in which the business is carried on, or expected to be carried

on, within the taxable year of the requested change, and grounds considered as justifying the requested revocation or new election. The Commissioner may require such other information as may be necessary in order to determine whether the proposed change will be permitted. Generally, a request for consent to revoke an election or make a new election will be granted if the basic nature of the taxpayer's business changes or if there are changes in conditions in a foreign country which substantially affect the taxpayer's business. For example, a taxpayer who enters substantial operations in a new foreign country or who loses an existing investment due to nationalization, expropriation, or war would be granted consent to revoke an election or make a new election.

(e) *Joint return*—(1) *General.* In the case of a husband and wife making a joint return, the applicable limitation prescribed by section 904(a) on the credit for taxes paid or accrued to foreign countries and possessions of the United States shall be applied with respect to the aggregate taxable income from sources within each such country or possession, or from sources without the United States, as the case may be, and the aggregate taxable income from all sources, of the spouses.

(2) *Electing the overall limitation.* If a husband and wife make a joint return for the current taxable year, but made a separate return for the preceding taxable year and the overall limitation applied for such preceding taxable year to one spouse or to both spouses (whether or not then married), then, unless revoked with the consent of the Commissioner, the overall limitation shall apply for the current taxable year and for subsequent taxable years of both spouses, whether or not they remain married, whether or not joint returns are filed for such subsequent taxable years, and whether or not one of such spouses could have elected the overall limitation for the current taxable year only with the consent of the Commissioner if he had filed a separate return for such year.

[T.D. 6789, 29 FR 19243, Dec. 31, 1964, as amended by T.D. 7294, 38 FR 33080, Nov. 30, 1973; T.D. 7490, 42 FR 30497, June 15, 1977; 42 FR 32536, June 27, 1977]

§ 1.904–2 Carryback and carryover of unused foreign tax.

(a) *Credit for foreign tax carryback or carryover.* A taxpayer who chooses to claim a credit under section 901 for a taxable year is allowed a credit under that section not only for taxes otherwise allowable as a credit but also for taxes deemed paid or accrued in that year as a result of a carryback or carryover of an unused foreign tax under section 904(c). However, the taxes so deemed paid or accrued shall not be allowed as a deduction under section 164(a). Paragraphs (b) through (g) of this section and §1.904–3, providing rules for the computation of carryovers and carrybacks, do not reflect a number of intervening statutory amendments, including the redesignation of section 904(d) as section 904(c) for taxable years beginning after 1975, amendments to sections 904(d) and (f) regarding the application of separate limitations in taxable years beginning after 1986, the limitation of the carryback period to one year for unused foreign taxes arising in taxable years beginning after October 22, 2004, and the extension of the carryover period to ten years for unused foreign taxes that may be carried to any taxable year ending after October 22, 2004. However, the principles of paragraphs (b) through (g) of this section and §1.904–3(b) through (g) shall apply in determining carrybacks and carryovers of unused foreign taxes, modified so as to take into account the effect of statutory amendments. For transition rules relating to the carryover and carryback of unused foreign tax paid with respect to dividends from noncontrolled section 902 corporations, *see* paragraph (h) of this section. For special rules regarding these computations in case of taxes paid, accrued, or deemed paid with respect to foreign oil and gas extraction income or foreign oil related income, see section 907(f) and the regulations under that section.

(b) *Years to which carried*—(1) *General.* If the taxpayer chooses the benefits of section 901 for a taxable year beginning after December 31, 1957, any unused foreign tax (as defined in subparagraph (2) of this paragraph) for such year shall, under section 904(d), be carried to the second preceding taxable year, the first

preceding taxable year, and the first, second, third, fourth, and fifth succeeding taxable years, in that order and to the extent not absorbed as taxes deemed paid or accrued, under paragraph (c) of this section, in a prior taxable year. The entire unused foreign tax for any taxable year shall first be carried to the earliest of the taxable years to which, under the preceding sentence, such unused foreign tax may be carried. Any portion of such unused foreign tax not deemed paid or accrued under paragraph (c) of this section in such earliest taxable year shall then be carried to the next earliest taxable year to which such unused foreign tax may be carried, and any portion not absorbed in that year shall then be carried to the next earliest year, and so on.

(2) *Definitions.* (i) When used with reference to a taxable year for which the per-country limitation provided in section 904(a)(1) applies, the term ''unused foreign tax'' means, with respect to a particular foreign country or possession of the United States, the excess of (*a*) the income, war profits, and excess profits taxes paid or accrued (or deemed paid or accrued other than by reason of section 904(d)) in such year to such foreign country or possession, over (*b*) the applicable per-country limitation under section 904(a)(1) for such year.

(ii) When used with reference to a taxable year for which the overall limitation provided in section 904(a)(2) applies, the term ''unused foreign tax'' means the excess of (*a*) the income, war profits, and excess profits taxes paid or accrued (or deemed paid or accrued other than by reason of section 904(d)) in such year to all foreign countries and possessions of the United States, over (*b*) the overall limitation under section 904(a)(2) for such year.

(iii) The term ''unused foreign tax'' does not include any amount by which the income, war profits, and excess profits taxes paid or accrued, or deemed to be paid, to any foreign country or possession of the United States with respect to foreign mineral income are reduced under section 901(e)(1) and § 1.901–3(b)(1).

(3) *Taxable years beginning before January 1, 1958.* For purposes of this paragraph, the terms ''second preceding taxable year'' and ''first preceding taxable year'' do not include any taxable year beginning before January 1, 1958.

(c) *Tax deemed paid or accrued*—(1) *Unused foreign tax for per-country limitation year.* (i) The amount of an unused foreign tax with respect to a particular foreign country or possession of the United States, for a taxable year for which the per-country limitation under section 904(a)(1) applies, which shall be deemed paid or accrued in any taxable year to which such unused foreign tax may be carried under paragraph (b) of this section shall, except as provided in subdivision (iii) of this subparagraph, be equal to the smaller of—

(*a*) The portion of such unused foreign tax which, under paragraph (b) of this section, is carried to such taxable year, or

(*b*) Any excess limitation for such taxable year with respect to such unused foreign tax (as determined under subdivision (ii) of this subparagraph).

(ii) The excess limitation for any taxable year (hereinafter called the ''excess limitation year'') with respect to an unused foreign tax in respect of a particular foreign country or possession of the United States for another taxable year (hereinafter called the ''year of origin'') shall be the amount, if any, by which the limitation for the excess limitation year with respect to that foreign country or possession (computed under section 904(a)(1)) exceeds the sum of—

(*a*) The income, war profits, and excess profits taxes actually paid or accrued to such foreign country or possession in the excess limitation year,

(*b*) The income, war profits, and excess profits taxes deemed paid or accrued in such year to such foreign country or possession other than by reason of section 904(d), and

(*c*) The portion of the unused foreign tax, with respect to such foreign country or possession for any taxable year earlier than the year of origin, which is absorbed as taxes deemed paid or accrued in the excess limitation year under subdivision (i) of this subparagraph.

(iii) An unused foreign tax for a taxable year for which the per-country limitation provided in section 904(a)(1)

applies shall not be deemed paid or accrued in a taxable year for which the overall limitation provided in section 904(a)(2) applies, notwithstanding that under paragraph (b) of this section such overall limitation year is counted as one of the years to which such unused foreign tax may be carried.

(iv) Any portion of an unused foreign tax with respect to a particular foreign country or possession of the United States which is deemed paid or accrued under section 904(d) in the year to which it is carried shall be deemed paid or accrued to the same foreign country or possession to which such foreign tax was paid or accrued (or deemed paid or accrued other than by reason of section 904(d)) for the year in which it originated.

(v) For determination of excess limitation for a year for which the taxpayer does not choose to claim a credit under section 901, see paragraph (d) of this section.

(2) *Unused foreign tax for overall limitation year.* (i) The amount of an unused foreign tax with respect to all foreign countries and possessions of the United States, for a taxable year for which the overall limitation provided in section 904(a)(2) applies, which shall be deemed paid or accrued in any taxable year to which such unused foreign tax may be carried under paragraph (b) of this section shall, except as provided in subdivision (iii) of this subparagraph, be equal to the smaller of—

(*a*) The portion of such unused foreign tax which, under paragraph (b) of this section is carried to such taxable year, or

(*b*) Any excess limitation for such taxable year with respect to such unused foreign tax (as determined under subdivision (ii) of this subparagraph).

(ii) The excess limitation for any taxable year (hereinafter called the ''excess limitation year'') with respect to an unused foreign tax in respect of all foreign countries and possessions of the United States for another taxable year (hereinafter called the ''year of origin'') shall be the amount, if any, by which the limitation for the excess limitation year with respect to all foreign countries and possessions of the United States (computed under section 904(a)(2)) exceeds the sum of—

(*a*) The income, war profits, and excess profits taxes actually paid or accrued to all foreign countries and possessions in the excess limitation year,

(*b*) The income, war profits, and excess profits taxes deemed paid or accrued in such year to all foreign countries and possessions other than by reason of section 904(d), and

(*c*) The portion of the unused foreign tax, with respect to all foreign countries and possessions for any taxable year earlier than the year of origin, which is absorbed as taxes deemed paid or accrued in the excess limitation year under subdivision (i) of this subparagraph.

(iii) An unused foreign tax for a taxable year for which the overall limitation provided in section 904(a)(2) applies shall not be deemed paid or accrued in a taxable year for which the per-country limitation provided in section 904(a)(1) applies, notwithstanding that under paragraph (b) of this section such per-country limitation year is counted as one of the years to which such unused foreign tax may be carried.

(iv) For determination of excess limitation for a year for which the taxpayer does not choose to claim a credit under section 901, see paragraph (d) of this section.

(3) *Unused foreign tax with respect to foreign mineral income.* If any portion of an unused foreign tax for any taxable year beginning after December 31, 1969, consists of tax paid or accrued, or deemed to be paid, with respect to foreign mineral income, as defined in §1.901–3(c), such portion shall not be deemed paid or accrued with respect to foreign mineral income in the taxable year to which it is carried under section 904(d).

(d) *Determination of excess limitation for certain years.* An excess limitation for a taxable year may exist, and may absorb all or some portion of an unused foreign tax, even though the taxpayer does not choose to claim a credit under section 901 for such year. In such case, the amount of the excess limitation, if any, for such year (hereinafter called the ''deduction year'') shall be determined in the same manner as though the taxpayer had chosen to claim a credit under section 901 for that year.

For purposes of the preceding sentence—

(1) If the taxpayer has not chosen the benefits of section 901 for any taxable year before the deduction year, the per-country limitation under section 904 (a)(1) shall be considered to be applicable for such year, and

(2) If the taxpayer has chosen the benefits of section 901 for any taxable year before the deduction year, the limitation (per-country or overall) applicable for the last taxable year (preceding such deduction year for) which a credit was claimed under section 901 shall be considered to be applicable for such deduction year.

(e) *Periods of less than 12 months.* A fractional part of a year which is a taxable year under sections 441(b) and 7701(a)(23) is a preceding or a succeeding taxable year for the purpose of determining under section 904(d) the years to which the unused foreign tax may be carried, and any unused foreign tax or excess limitation for such fractional part of a year is the unused foreign tax or excess limitation for a taxable year.

(f) *Statement with tax return.* Every taxpayer claiming the benefit of a carryback or carryover of the unused foreign tax to any taxable year for which he chooses to claim a credit under section 901 shall file with his return (or with his claim for refund, if appropriate) for that year as an attachment to his Form 1116 or 1118, as the case may be, a statement setting forth the unused foreign tax deemed paid or accrued under this section and all material and pertinent facts relative thereto, including a detailed schedule showing the computation of the unused foreign tax so carried back or over.

(g) *Illustration of carrybacks and carryovers.* The application of this section may be illustrated by the following examples:

Example 1. (i) A, a calendar year taxpayer using the cash receipts and disbursements method of accounting, chooses to claim a credit under section 901 for each of the taxable years set forth below. Based upon the taxes actually paid to country X, and the section 904(a)(1) limitation applicable in respect of country X, in each of the taxable years, the unused foreign tax deemed paid under section 904(d) in each of the appropriate taxable years is as follows:

	Taxable years								
	1958	1959	1960	1961	1962	1963	1964	1965	1966
Per-country limitation	$175	$150	$100	$100	$100	$300	$400	$200	$600
Taxes actually paid to country X in taxable year	75	60	830	170	150	100	200	140	400
Unused foreign tax to be carried back or over from year of origin	.....	.....	730	70	50	.....	.....	.....	.....
Excess limitation with respect to unused foreign tax for—									
1960	(100)	(90)	.....	.....	.....	(200)	(200)	(60)	.....
1961	.....	.....	.....	.....	.....	.....	.....	.....	(200)
1962	.....	.....	.....	.....	.....	.....	.....	.....	(130)
Unused foreign tax absorbed as taxes deemed paid under the carryback and carryover provisions as carried from—									
1960	100	90	.....	.....	.....	200	200	60	.....
1961	.....	.....	.....	.....	.....	.....	.....	.....	70
1962	.....	.....	.....	.....	.....	.....	.....	.....	50

(ii) The excess limitation for 1958, 1959, 1963, 1964, and 1965, respectively, which is available to absorb the unused foreign tax for 1960 is the amount by which the per-country limitation for each of those years exceeds the taxes actually paid to country X in each such year. The unused foreign tax for 1961 and 1962 are not taken into account, since neither of those years is a year earlier than 1960, the year of origin in respect of which the excess limitation is being determined. Thus, for example, the excess limitation for 1963 is $200, unreduced by the unused foreign tax for 1961 and 1962. There is no excess limitation for 1966 with respect to the unused foreign tax for 1960, since the unused foreign tax may be carried forward only 5 taxable years. The unused foreign tax ($730) for 1960 is thus absorbed as taxes deemed paid to the extent of the excess limitation for each of the taxable years 1958, 1959, 1963, 1964, and 1965, respectively, and in that order,

leaving unused foreign tax in the amount of $80 which cannot be absorbed because it cannot be carried beyond 1965.

(iii) The amount of unused foreign tax for 1961 which is deemed paid in 1966 is $70, the smaller of (*a*) that portion of the unused foreign tax carried to 1966 ($70), or (*b*) the excess limitation for 1966 with respect to such unused foreign tax ($200). The unused foreign tax for 1962 ($50) is not taken into account for such purposes, since that year is not a year earlier than 1961, the year of origin in respect of which the excess limitation for 1966 is being determined.

(iv) The excess limitation for 1966 with respect to the unused foreign tax for 1962 is $130, the amount by which the limitation applicable under section 904(a)(1) for 1966 ($600) exceeds the sum of the taxes actually paid ($400) to country X in that year and the unused foreign tax ($70) for 1961 which is absorbed in 1966 as taxes deemed paid and which is carried from a taxable year earlier than 1962, the year of origin in respect of which the excess limitation is being determined. The unabsorbed part ($80) of the unused foreign tax for 1960, a year earlier than 1962, is not taken into account in computing the excess limitation for 1966, since the unused foreign tax for 1960 may not be carried beyond 1965. The unused foreign tax ($50) for 1962 is thus absorbed in full in 1966 as taxes deemed paid, since the unused foreign tax does not exceed the excess limitation ($130) for that year.

Example 2. Assume the same facts as those in example 1 except that the taxpayer does not choose to have the benefits of section 901 for 1961. In that case there is no unused foreign tax for that year to carry back or over to be absorbed in other taxable years as taxes deemed paid. Moreover, the excess limitation for 1966 which is available to absorb the unused foreign tax for 1962 is $200, instead of $130, that is, the amount by which the limitation applicable under section 904(a)(1) for 1966 ($600) exceeds the taxes actually paid ($400) to country X in that year. The amount of the unused foreign tax absorbed in each taxable year as taxes deemed paid is the same as in example 1 except for 1966. In that year only the unused foreign tax ($50) for 1962 is absorbed as taxes deemed paid.

Example 3. Assume the same facts as those in example 1 except that the taxpayer does not choose the benefits of section 901 for 1959. Since the excess limitation for a taxable year for which the taxpayer does not claim a credit under section 901 is determined in the same manner as though the taxpayer had chosen such credit, the excess limitation for 1959 is determined to be $90 just as in example 1. Moreover, even though such excess limitation absorbs a carryback of $90 from the unused tax for 1960, none of such $90 so deemed paid in 1959 is allowed as a deduction under section 164 or as a credit under section 901 for 1959 or for any other taxable year.

Example 4. (i) B, a calendar year taxpayer using the cash receipts and disbursements methods of accounting, chooses the benefits of section 901 for each of the taxable years 1957, 1958, and 1959. Based upon the taxes actually paid to country Y and the per-country limitation applicable with respect to country Y, in each of the taxable years, the unused foreign tax deemed paid under section 904(d) for taxable year 1959 is as follows:

	Taxable years		
	1957	1958	1959
Per-country limitation on credit for taxes paid to Y	$300	$200	$250
Taxes actually paid to Y in taxable year	200	300	150
Unused foreign tax to be carried back or over from year of origin	.....	100	.....
Excess limitation applicable to unused credit	.....	.....	(100)
Unused foreign tax absorbed as taxes deemed paid	.....	.....	100

(ii) Since a taxable year beginning before January 1, 1958, cannot constitute a preceding taxable year in which the unused foreign tax for 1958 may be absorbed as taxes deemed paid, the entire unused foreign tax ($100) is absorbed as taxes deemed paid in 1959.

Example 5. (i) C, a calendar year taxpayer using an accrual method of accounting, accrues foreign taxes for the first time in 1961. C chooses the benefits of section 901 for each of the taxable years set forth below and for 1962 elects the overall limitation provided by section 904(a)(2) which, with the Commissioner's consent, is revoked for 1966. Based upon the taxes actually accrued with respect to foreign countries X and Y for each of the taxable years, the unused foreign tax deemed accrued under section 904(d) in the appropriate taxable years is as follows:

	Per country	Overall	Overall	Overall	Overall	Per country
Taxable years	1961	1962	1963	1964	1965	1966
Limitation:						
Country X	$175	.....	.....	.....	.....	$290
Country Y	125	.....	.....	.....	.....	95
Overall	.....	$250	$800	$300	$400	.....

	Per country	Overall	Overall	Overall	Overall	Per country
Taxes actually accrued:						
Country X	325	.....	.....	.....	.....	200
Country Y	85	.....	.....	.....	.....	100
Aggregate	.....	350	380	425	450	.....
Unused foreign tax to be carried back or over from year of origin:						
Country X	150	.....	.....	.....	.....	.....
Country Y	.....	.....	.....	.....	.....	5
Aggregate	.....	100	.....	125	50	.....
Excess limitation:						
Country X	.....	.....	.....	.....	.....	90
Country Y	40	.....	.....	.....	.....	.....
Overall	.....	.....	420	.....	.....	.....
Unused foreign tax absorbed as taxes deemed accrued under section 904(d) and carried from—						
1961 (Country X)	.....	.....	.....	.....	.....	(90)
1962 (Overall)	.....	.....	(100)	.....	.....	.....
1964 (Overall)	.....	.....	(125)	.....	.....	.....
1965 (Overall)	.....	.....	(50)	.....	.....	.....

(ii) Since the per-country limitation is applicable for 1961 and 1966 only, any unused foreign tax with respect to such years may not be deemed accrued in 1962, 1963, 1964, or 1965, years for which the overall limitation applies. However, the excess limitation for 1966 with respect to country X ($90) is available to absorb a part of the unused foreign tax for 1961 with respect to country X. The difference with respect to country X between the unused foreign tax for 1961 ($150) and the amount absorbed as taxes deemed accrued ($90) in 1966, or $60, may not be carried beyond 1966 since the unused foreign tax may be carried forward only 5 taxable years. There is no excess limitation with respect to country Y for 1961 in respect of the unused foreign tax of country Y for 1966, since the unused foreign tax may be carried back only 2 taxable years.

(iii) Since the overall limitation is applicable for 1962, 1963, 1964, and 1965, any unused foreign tax with respect to such years may not be absorbed as taxes deemed accrued in 1961 or 1966, years for which the per-country limitation applies. However, the excess limitation for 1963 ($420) computed on the basis of the overall limitation is available to absorb the unused foreign tax for 1962 ($100), the unused foreign tax for 1964 ($125), and the unused foreign tax for 1965 ($50), leaving an excess limitation above such absorption of $145 ($420–$275).

(h) *Transition rules for carryovers and carrybacks of pre-2003 and post-2002 unused foreign tax paid or accrued with respect to dividends from noncontrolled section 902 corporations*—(1) *Carryover of unused foreign tax*. Except as provided in §§ 1.904–7(f)(9)(iv) and 1.904(f)–12(g)(3), the rules of this paragraph (h)(1) apply to reallocate to the taxpayer's other separate categories any unused foreign taxes (as defined in paragraph (b)(2) of this section) that were paid or accrued or deemed paid under section 902 with respect to a dividend from a noncontrolled section 902 corporation paid in a taxable year of the noncontrolled section 902 corporation beginning before January 1, 2003, which taxes were subject to a separate limitation for dividends from that noncontrolled section 902 corporation. To the extent any such unused foreign taxes are carried forward to a taxable year of a domestic shareholder beginning on or after the first day of the noncontrolled section 902 corporation's first taxable year beginning after December 31, 2002, such taxes shall be allocated among the taxpayer's separate categories in the same proportions as the related dividend would have been assigned had such dividend been eligible for look-through treatment when paid. Accordingly, the taxes shall be allocated in the same percentages as the reconstructed earnings in the noncontrolled section 902 corporation's non-look-through pool and pre-1987 accumulated profits that were accumulated in taxable years beginning before January 1, 2003, out of which the dividend was paid, in accordance with the rules of § 1.904–7(f), or, if the taxpayer uses the safe harbor method of § 1.904–7(f)(4)(ii), in the same percentages as the taxpayer properly

characterizes the stock of the noncontrolled section 902 corporation for purposes of apportioning its interest expense in its first taxable year ending after the first day of the noncontrolled section 902 corporation's first taxable year beginning after December 31, 2002. *See* §1.904–7(f)(2) and (4). In the case of unused foreign taxes allocable to dividends from a noncontrolled section 902 corporation with respect to which the taxpayer was no longer a domestic shareholder (as defined in §1.902–1(a)) as of the first day of such taxable year, such taxes shall be allocated among the taxpayer's separate categories in the same percentages as the earnings in the noncontrolled section 902 corporation's non-look-through pool or pre-1987 accumulated profits would have been assigned had they been distributed and eligible for look-through treatment in the last taxable year in which the taxpayer was a domestic shareholder in such corporation. The unused foreign taxes that are carried forward shall be treated as allocable to general limitation income to the extent that such taxes would otherwise have been allocable to passive income, either on a look-through basis or as a result of inadequate substantiation under the rules of §1.904–7(f)(4).

(2) *Carryback of unused foreign tax*. The rules of this paragraph (h)(2) apply to any unused foreign taxes that were paid or accrued or deemed paid under section 902 with respect to a dividend from a noncontrolled section 902 corporation paid in a taxable year of the noncontrolled section 902 corporation ending on or after April 20, 2009, which dividends were eligible for look-through treatment. *See* 26 CFR §1.904–2T(h)(2) (revised as of April 1, 2009) for rules applicable to such unused foreign taxes with respect to a dividend from a noncontrolled section 902 corporation paid in a taxable year of the noncontrolled section 902 corporation beginning after December 31, 2002 and ending before April 20, 2009, which dividends were eligible for look-through treatment. To the extent any such unused foreign taxes are carried back to a prior taxable year of a domestic shareholder, a credit for such taxes shall be allowed only to the extent of the excess limitation in the same separate category or categories to which the related look-through dividend was assigned and not in any separate category for dividends from noncontrolled section 902 corporations.

(i) *Transition rules for carryovers and carrybacks of pre-2007 and post-2006 unused foreign tax*—(1) *Carryover of unused foreign tax*—(i) *General rule*. For purposes of this paragraph (i), the terms *post-2006 separate category* and *pre-2007 separate category* have the meanings set forth in §1.904–7(g)(1)(ii) and (iii). The rules of this paragraph (i)(1) apply to reallocate to the taxpayer's post-2006 separate categories for general category income and passive category income any unused foreign taxes (as defined in §1.904–2(b)(2)) that were paid or accrued or deemed paid under section 902 with respect to income in a pre-2007 separate category (other than a category described in §1.904–4(m)). To the extent any such unused foreign taxes are carried forward to a taxable year beginning after December 31, 2006, such taxes shall be allocated to the taxpayer's post-2006 separate categories to which those taxes would have been allocated if the taxes were paid or accrued in a taxable year beginning after December 31, 2006. For example, any foreign taxes paid or accrued or deemed paid with respect to financial services income in a taxable year beginning before January 1, 2007, that are carried forward to a taxable year beginning after December 31, 2006, will be allocated to the general category because the financial services income to which those taxes relate would have been allocated to the general category if it had been earned in a taxable year beginning after December 31, 2006.

(ii) *Safe harbor*. In lieu of applying the rules of paragraph (i)(1)(i) of this section, a taxpayer may allocate all unused foreign taxes in the pre-2007 separate category for passive income to the post-2006 separate category for passive category income, and allocate all other unused foreign taxes described in paragraph (i)(1)(i) of this section to the post-2006 separate category for general category income. A taxpayer may choose to use the safe harbor method on a timely filed (original or amended) tax return or during an audit. A taxpayer that uses the safe harbor method

on an amended return or in the course of an audit must make appropriate adjustments to eliminate any double benefit arising from application of the safe harbor method to years that are not open for assessment. A taxpayer's choice to use the safe harbor method is evidenced by employing the method. The taxpayer need not file any separate statement.

(2) *Carryback of unused foreign tax*—(i) *General rule*. The rules of this paragraph (i)(2) apply to any unused foreign taxes that were paid or accrued or deemed paid under section 902 with respect to income in a post-2006 separate category (other than a category described in §1.904–4(m)). To the extent any such unused foreign taxes are carried back to a taxable year beginning before January 1, 2007, a credit for such taxes shall be allowed only to the extent of the excess limitation in the pre-2007 separate category, or categories, to which the taxes would have been allocated if the taxes were paid or accrued in a taxable year beginning before January 1, 2007. For example, any foreign taxes paid or accrued or deemed paid with respect to income in the general category in a taxable year beginning after December 31, 2006, that are carried back to a taxable year beginning before January 1, 2007, will be allocated to the same separate categories to which the income would have been allocated if such income had been earned in a taxable year beginning before January 1, 2007.

(ii) *Safe harbor*. In lieu of applying the rules of paragraph (i)(2)(i) of this section, a taxpayer may allocate all unused foreign taxes in the post-2006 separate category for passive category income to the pre-2007 separate category for passive income, and may allocate all other unused foreign taxes described in paragraph (i)(2)(i) of this section to the pre-2007 separate category for general limitation income. A taxpayer may choose to use the safe harbor method on a timely filed (original or amended) tax return or during an audit. A taxpayer that uses the safe harbor method on an amended return or in the course of an audit must make appropriate adjustments to eliminate any double benefit arising from application of the safe harbor method to years that are not open for assessment. A taxpayer's choice to use the safe harbor method is evidenced by employing the method. The taxpayer need not file any separate statement.

(3) *Effective/applicability date*. This paragraph (i) applies to taxable years beginning after December 31, 2006 and ending on or after December 21, 2007.

[T.D. 6789, 29 FR 19244, Dec. 31, 1964, as amended by T.D. 7294, 38 FR 33081, Nov. 30, 1973; T.D. 7292, 38 FR 33292, Dec. 3, 1973; T.D. 7490, 42 FR 30497, June 15, 1977; T.D. 7961, 49 FR 26225, June 27, 1984; 49 FR 29594, July 23, 1984; T.D. 9260, 71 FR 24529, Apr. 25, 2006; T.D. 9368, 72 FR 72587, Dec. 21, 2007; T.D. 9452, 74 FR 27877, June 11, 2009; T.D. 9521, 76 FR 19270, Apr. 7, 2011]

§1.904–3 Carryback and carryover of unused foreign tax by husband and wife.

(a) *In General*. This section provides rules, in addition to those prescribed in §1.904–2, for the carryback and carryover of the unused foreign tax paid or accrued to a foreign country or possession by a husband and wife making a joint return for one or more of the taxable years involved in the computation of the carryback or carryover.

(b) *Joint unused foreign tax and joint excess limitation*. In the case of a husband and wife the joint unused foreign tax or the joint excess limitation for a taxable year for which a joint return is made shall be computed on the basis of the combined income, deductions, taxes, and credit of both spouses as if the combined income, deductions, taxes, and credit were those of one individual.

(c) *Continuous use of joint return*. If a husband and wife make a joint return for the current taxable year, and also make joint returns for each of the other taxable years involved in the computation of the carryback or carryover of the unused foreign tax to the current taxable year, the joint carryback or the joint carryover to the current taxable year shall be computed on the basis of the joint unused foreign tax and the joint excess limitations.

(d) *From separate to joint return*. If a husband and wife make a joint return for the current taxable year, but make separate returns for all of the other taxable years involved in the computation of the carryback or carryover of

the unused foreign tax to the current taxable year, the separate carrybacks or separate carryovers shall be a joint carryback or a joint carryover to the current taxable year. If for such current year the per-country limitation applies, then only the unused foreign tax for a taxable year of a spouse for which the per-country limitation applied to such spouse may constitute a carryover or carryback to the current taxable year. If for such current taxable year the overall limitation applies, then only the unused foreign tax for a taxable year of a spouse for which the overall limitation applied to such spouse may constitute a carryover or carryback to the current taxable year.

(e) *Amounts carried from or through a joint return year to or through a separate return year.* It is necessary to allocate to each spouse his share of an unused foreign tax or excess limitation for any taxable year for which the spouses filed a joint return if—

(1) The husband and wife file separate returns for the current taxable year and an unused foreign tax is carried thereto from a taxable year for which they filed a joint return;

(2) The husband and wife file separate returns for the current taxable year and an unused foreign tax is carried to such taxable year from a year for which they filed separate returns but is first carried through a year for which they filed a joint return; or

(3) The husband and wife file a joint return for the current taxable year and an unused foreign tax is carried from a taxable year for which they filed joint returns but is first carried through a year for which they filed separate returns.

In such cases, the separate carryback or carryover of each spouse to the current taxable year shall be computed in the manner described in §1.904–2 but with the modifications set forth in paragraph (f) of this section. Where applicable, appropriate adjustments shall be made to take into account the fact that, for any taxable year involved in the computation of the carryback or the carryover, either spouse has interest income described in section 904(f)(2) with respect to which the provisions of section 904(f) and §1.904–4 apply, or dividends described in section 904(f)(1)(B) with respect to which the provisions of section 904(f) and §1.904–5 apply, or foreign oil related income described in section 907(c) with respect to which the separate limitation in section 907(b) applies.

(f) *Allocation of unused foreign tax and excess limitation*—(1) *Limitation*—(i) *Per-country limitation.* The per-country limitation of a particular spouse with respect to a foreign country or United States possession for a taxable year for which a joint return is made shall be the portion of the limitation on the joint return which bears the same ratio to such limitation as such spouse's taxable income (with gross income and deductions taken into account to the same extent as taken into account on the joint return) from sources within such country or possession (but not in excess of the joint taxable income from sources within such country or possession) bears to the joint taxable income from such sources.

(ii) *Overall limitation.* The overall limitation of a particular spouse for a taxable year for which a joint return is made shall be the portion of the limitation on the joint return which bears the same ratio to such limitation as such spouse's taxable income (with gross income and deductions taken into account to the same extent as taken into account on the joint return) from sources without the United States (but not in excess of the joint taxable income from such sources) bears to the joint taxable income from such sources.

(2) *Unused foreign tax*—(i) *Per-country limitation.* The unused foreign tax of a particular spouse with respect to a foreign country or United States possession for a taxable year for which a joint return is made shall be the excess of his tax paid or accrued to such country or possession over his limitation determined under subparagraph (1)(i) of this paragraph.

(ii) *Overall limitation.* The unused foreign tax of a particular spouse for a taxable year to which the overall limitation applies and for which a joint return is made shall be the excess of his tax paid or accrued to foreign countries and United States possessions over his limitation determined under subparagraph (1)(ii) of this paragraph.

(3) *Excess limitation*—(i) *Per-country limitation taxpayer*. A spouse's excess limitation with respect to a foreign country or possession for a taxable year for which a joint return is made shall be the excess of his limitation determined under subparagraph (1)(i) of this paragraph over his taxes paid or accrued to such country or possession for such taxable year.

(ii) *Overall limitation*. A spouse's excess limitation for a taxable year to which the overall limitation applies and for which a joint return is made shall be the excess of his limitation determined under subparagraph (1)(ii) of this paragraph over his taxes paid or accrued to foreign countries and United States possessions for such taxable year.

(4) *Excess limitation to be applied*. The excess limitation of the particular spouse for any taxable year which is applied against the unused foreign tax of that spouse for another taxable year in order to determine the amount of the unused foreign tax which shall be carried back or over to a third taxable year shall be, in a case in which the excess limitation is determined on a joint return, the sum of the following amounts:

(i) Such spouse's excess limitation determined under subparagraph (3) of this paragraph reduced as provided in subparagraph (5)(i) of this paragraph, and

(ii) The excess limitation of the other spouse determined under subparagraph (3) of this paragraph for that taxable year reduced as provided in subparagraphs (5) (i) and (ii) of this paragraph.

(5) *Reduction of excess limitation*. (i) The part of the excess limitation which is attributable to each spouse for the taxable year, as determined under subparagraph (3) of this paragraph, shall be reduced by absorbing as taxes deemed paid or accrued under section 904(d) in that year the unabsorbed separate unused foreign tax of such spouse, and the unabsorbed unused foreign tax determined under subparagraph (2) of this paragraph of such spouse, for taxable years which begin before the beginning of the year of origin of the unused foreign tax of the particular spouse against which the excess limitation so determined is being applied.

(ii) In addition, the part of the excess limitation which is attributable to the other spouse for the taxable year, as determined under subparagraph (3) of this paragraph, shall be reduced by absorbing as taxes deemed paid or accrued under section 904(d) in that year the unabsorbed unused foreign tax, if any, of such other spouse for the taxable year which begins on the same date as the beginning of the year of origin of the unused foreign tax of the particular spouse against which the excess limitation so determined is being applied.

(6) *Spouses using different limitations*. If an unused foreign tax is carried through a taxable year for which spouses made a joint return and the credit under section 901 for such taxable year is not claimed, and in the prior taxable year separate returns are made in which the per-country limitation applies to one spouse and the overall limitation applies to the other spouse, the amount treated as absorbed in the taxable year for which a joint return is made—

(i) With respect to the spouse for which the per-country limitation applies shall be determined on the basis of the excess limitation which would be allocated to such spouse under subparagraph (3)(i) of this paragraph had the per-country limitation applied for such year to both spouses;

(ii) With respect to the other spouse for which the overall limitation applies shall be determined on the basis of the excess limitation which would be allocated to such spouse under subparagraph (3)(ii) of this paragraph had the overall limitation applied for such year to both spouses.

This subparagraph shall be applied without regard to subparagraph (4)(ii) of this paragraph.

(g) *Illustrations*. This section may be illustrated by the following examples:

Example 1. (a) H and W, calendar year taxpayers, file joint returns for 1961 and 1963, and separate returns for 1962, 1964, and 1965; and for each of those taxable years they choose to claim a credit under section 901. For the taxable years involved, they had unused foreign tax, excess limitations, and carrybacks and carryovers of unused foreign tax as set forth below. The overall limitation applies to both spouses for all taxable years

involved in this example. Neither H nor W had an unused foreign tax or excess limitation for any year before 1961 or after 1965. For purposes of this example, any reference to an excess limitation means such a limitation as determined under paragraph (c)(2)(ii) of §1.904–2 but without regard to any taxes deemed paid or accrued under section 904(d):

	Taxable year				
	1961	1962	1963	1964	1965
Return	Joint	Separate	Joint	Separate	Separate
H's unused foreign tax to be carried over or back, or excess limitation (enclosed in parentheses)	$500	$250	($650)	$400	($500)
W's unused foreign tax to be carried over or back, or excess limitation (enclosed in parentheses)	300	(200)	(300)	150	(100)
Total	800	.....	(950)	.....	.....
Carryovers absorbed:					
W's, from 1961	.....	[1] 200W	100W	.....	.....
H's, from 1961	.....	.....	[2] 500H	.....	.....
H's, from 1962	.....	.....	150H	.....	.....
	.....	.....	100W	.....	.....
W's, from 1964	.....	.....	.....	.....	50W
H's, from 1964	.....	.....	.....	.....	400H
Carrybacks absorbed:					
W's, from 1964	.....	0	100W	.....	.....
H's, from 1964	.....	.....	0	.....	.....

[1] W—absorbed by W's excess limitation.
[2] H—absorbed by H's excess limitation.

(b) Two hundred dollars of the $300 constituting W's part of the joint unused foreign tax for 1961 is absorbed by her separate excess limitation of $200 for 1962, and the remaining $100 of such part is absorbed by her part ($300) of the joint excess limitation for 1963. The excess limitation of $300 for 1963 is not required first to be reduced by any amount, since neither H nor W has any unused foreign tax for taxable years beginning before 1961.

(c) H's part ($500) of the joint unused foreign tax for 1961 is absorbed by his part ($650) of the joint excess limitation for 1963. The excess limitation of $650 for 1963 is not required first to be reduced by any amount, since neither H nor W has any unused foreign tax for taxable years beginning before 1961.

(d) H's unused foreign tax of $250 for 1962 is first absorbed (to the extent of $150) by H's part of the joint excess limitation for 1963, which must first be reduced from $650 to $150 by the absorption as taxes deemed paid or accrued in 1963 of H's unused foreign tax of $500 for 1961, which is a taxable year beginning before 1962. The remaining part ($100) of H's unused foreign tax for 1962 is then absorbed by W's part of the joint excess limitation for 1963, which must first be reduced from $300 to $200 by the absorption as taxes deemed paid or accrued in 1963 of the unabsorbed part $100 of W's unused foreign tax for 1961, which is a taxable year beginning before 1962.

(e) W's unused foreign tax of $150 for 1964 is first absorbed (to the extent of $100) by W's part of the joint excess limitation for 1963, which must first be reduced from $300 to $100 by the absorption as taxes deemed paid or accrued in 1963 of the unabsorbed part ($100) of W's unused foreign tax for 1961 and the unabsorbed part ($100) of H's unused foreign tax for 1962, which are taxable years beginning before 1964. No part of W's unused foreign tax for 1964 is absorbed by H's part of the joint excess limitation for 1963, since H's part of that excess must first be reduced from $650 to $0 by the absorption as taxes deemed paid or accrued in 1963 of H's unused foreign tax of $500 for 1961 and of the unabsorbed part ($150) of H's unused foreign tax for 1962, which are taxable years beginning before 1964. The unabsorbed part ($50) of W's unused foreign tax for 1964 is then absorbed by W's excess limitation of $100 for 1965. No part of W's unused foreign tax for 1964 is absorbed by W's excess limitation for 1962, since that excess limitation must first be reduced from $200 to $0 by W's unused foreign tax for 1961, which is a taxable year beginning before 1964.

(f) No part of H's unused foreign tax of $400 for 1964 is absorbed by H's part of the joint excess limitation for 1963, since H's part of that excess must first be reduced from $650 to $0 by the absorption as taxes deemed paid or accrued in 1963 of H's unused foreign tax of $500 for 1961 and of a part ($150) of H's unused foreign tax for 1962, which are taxable years beginning before 1964. Moreover, no part of H's unused foreign tax of $400 for 1964 is absorbed by W's part of the joint excess limitation for 1963, since W's part of that excess must first be reduced from $300 to $0 by the absorption as taxes deemed paid or accrued in 1963 of the unabsorbed part ($100) of

W's unused foreign tax for 1961 and of the unabsorbed part ($100) of H's unused foreign tax for 1962, which are taxable years beginning before 1964, and also by the absorption of a part ($100) of W's unused foreign tax of $150 for 1964, which is a taxable year beginning on the same date as the beginning of H's taxable year 1964. The unabsorbed part ($400) of H's unused foreign tax for 1964 is then absorbed by H's excess limitation of $500 for 1965.

Example 2. (a) Assume the same facts as those in example 1 except that for 1964 W's unused foreign tax is $20, instead of $150. The carrybacks and carryovers absorbed are the same as in example 1 except as indicated in paragraphs (b) and (c) of this example.

(b) No part of W's unused foreign tax of $20 for 1964 is absorbed by W's excess limitation for 1962, since that excess must first be reduced from $200 to $0 by W's unused foreign tax for 1961, which is a taxable year beginning before 1964. W's unused foreign tax of $20 for 1964 is absorbed by W's part of the joint excess limitation for 1963, which must first be reduced from $300 to $100 by the absorption as taxes deemed paid or accrued in 1963 of the unabsorbed part ($100) of W's unused foreign tax for 1961 and the unabsorbed part ($100) of H's unused foreign tax for 1962, which are taxable years beginning before 1964.

(c) For the reason given in paragraph (f) of example 1, no part of H's unused foreign tax of $400 for 1964 is absorbed by H's part of the joint excess limitation for 1963. H's unused foreign tax of $400 for 1964 is first absorbed (to the extent of $80) by W's part of the joint excess limitation for 1963, which must first be reduced from $300 to $80 by the absorption as taxes deemed paid or accrued in 1963 of the unabsorbed part ($100) of W's unused foreign tax for 1961 and of the unabsorbed part ($100) of H's unused foreign tax for 1962, which are taxable years beginning before 1964, and also by the absorption of W's unused foreign tax of $20 for 1964, which is a taxable year beginning on the same date as the beginning of H's taxable year 1964. The unabsorbed part ($320) of H's unused foreign tax for 1964 is then absorbed by H's excess limitation of $500 for 1965.

Example 3. The facts are the same as in example 1 except that the per-country limitation applies to both spouses for all taxable years involved in the example and that excess limitations and the unused foreign taxes relate to a single foreign country. The carryovers and carrybacks are the same as in example 1.

[T.D. 6789, 29 FR 19246, Dec. 31, 1964, as amended by T.D. 7292, 38 FR 33292, Dec. 3, 1973; T.D. 7490, 42 FR 30497, June 15, 1977; T.D. 7961, 49 FR 26225, June 27, 1984]

§ 1.904–4 Separate application of section 904 with respect to certain categories of income.

(a) *In general.* A taxpayer is required to compute a separate foreign tax credit limitation for income received or accrued in a taxable year that is described in section 904(d)(1)(A) (passive category income), 904(d)(1)(B) (general category income), or § 1.904–4(m) (additional separate categories).

(b) *Passive category income*—(1) *In general.* The term *passive category income* means passive income and specified passive category income.

(2) *Passive income*—(i) *In general.* The term *passive income* means any—

(A) Income received or accrued by any person that is of a kind that would be foreign personal holding company income (as defined in section 954(c)) if the taxpayer were a controlled foreign corporation, including any amount of gain on the sale or exchange of stock in excess of the amount treated as a dividend under section 1248; or

(B) Amount includible in gross income under section 1293.

(ii) *Exceptions.* Passive income does not include any export financing interest (as defined in section 904(d)(2)(G) and paragraph (h) of this section), any high-taxed income (as defined in section 904(d)(2)(F) and paragraph (c) of this section), or any active rents and royalties (as defined in paragraph (b)(2)(iii) of this section). In addition, passive income does not include any income that would otherwise be passive but is characterized as income in another separate category under the look-through rules of section 904(d)(3), (d)(4), and (d)(6)(C) and the regulations under those provisions. In determining whether any income is of a kind that would be foreign personal holding company income, the rules of section 864(d)(5)(A)(i) and (6) (treating related person factoring income of a controlled foreign corporation as foreign personal holding company income that is not eligible for the export financing income exception to the separate limitation for passive income) shall apply only in the case of income of a controlled foreign corporation (as defined in section 957). Thus, income earned directly by a United States person that is related

person factoring income may be eligible for the exception for export financing interest.

(iii) *Active rents or royalties*—(A) *In general*. For rents and royalties paid or accrued after September 20, 2004, passive income does not include any rents or royalties that are derived in the active conduct of a trade or business, regardless of whether such rents or royalties are received from a related or an unrelated person. Except as provided in paragraph (b)(2)(iii)(B) of this section, the principles of section 954(c)(2)(A) and the regulations under that section shall apply in determining whether rents or royalties are derived in the active conduct of a trade or business. For this purpose, the term taxpayer shall be substituted for the term controlled foreign corporation if the recipient of the rents or royalties is not a controlled foreign corporation.

(B) *Active conduct of trade or business*. Rents and royalties are considered derived in the active conduct of a trade or business by a United States person or by a controlled foreign corporation (or other entity to which the look-through rules apply) for purposes of section 904 (but not for purposes of section 954) if the requirements of section 954(c)(2)(A) are satisfied by one or more corporations that are members of an affiliated group of corporations (within the meaning of section 1504(a), determined without regard to section 1504(b)(3)) of which the recipient is a member. For purposes of this paragraph (b)(2)(iii)(B), an affiliated group includes only domestic corporations and foreign corporations that are controlled foreign corporations in which domestic members of the affiliated group own, directly or indirectly, at least 80 percent of the total voting power and value of the stock. For purposes of this paragraph (b)(2)(iii)(B), indirect ownership shall be determined under section 318 and the regulations under that section.

(iv) *Examples*. The following examples illustrate the application of paragraph (b)(2) of this section.

Example 1. P is a domestic corporation with a branch in foreign country X. P does not have any financial services income. For 2008, P has a net foreign currency gain that would not constitute foreign personal holding company income if P were a controlled foreign corporation because the gain is directly related to the business needs of P. The currency gain is, therefore, general category income to P because it is not income of a kind that would be foreign personal holding company income.

Example 2. Controlled foreign corporation S is a wholly-owned subsidiary of P, a domestic corporation. S is regularly engaged in the restaurant franchise business. P licenses trademarks, tradenames, certain know-how, related services, and certain restaurant designs for which S pays P an arm's length royalty. P is regularly engaged in the development and licensing of such property. The royalties received by P for the use of its property are allocable under the look-through rules of §1.904–5 to the royalties S receives from the franchisees. Some of the franchisees are unrelated to S and P. Other franchisees are related to S or P and use the licensed property outside of S's country of incorporation. S does not satisfy, but P does satisfy, the active trade or business requirements of section 954(c)(2)(A) and the regulations under that section. The royalty income earned by S with regard to both its related and unrelated franchisees is foreign personal holding company income because S does not satisfy the active trade or business requirements of section 954(c)(2)(A) and, in addition, the royalty income from the related franchisees does not qualify for the same country exception of section 954(c)(3). However, all of the royalty income earned by S is general category income to S under §1.904–4(b)(2)(iii) because P, a member of S's affiliated group (as defined therein), satisfies the active trade or business test (which is applied without regard to whether the royalties are paid by a related person). S's royalty income that is taxable to P under subpart F and the royalties paid to P are general category income to P under the look-through rules of §1.904–5(c)(1)(i) and (c)(3), respectively.

(3) *Specified passive category income* means—

(i) Dividends from a DISC or former DISC (as defined in section 992(a)) to the extent such dividends are treated as income from sources without the United States;

(ii) Taxable income attributable to foreign trade income (within the meaning of section 923(b)); or

(iii) Distributions from a FSC (or a former FSC) out of earnings and profits attributable to foreign trade income (within the meaning of section 923(b)) or interest or carrying charges (as defined in section 927(d)(1)) derived from a transaction which results in foreign

trade income (as defined in section 923(b)).

(c) *High-taxed income*—(1) *In general.* Income received or accrued by a United States person that would otherwise be passive income shall not be treated as passive income if the income is determined to be high-taxed income. Income shall be considered to be high-taxed income if, after allocating expenses, losses and other deductions of the United States person to that income under paragraph (c)(2)(ii) of this section, the sum of the foreign income taxes paid or accrued by the United States person with respect to such income and the foreign taxes deemed paid or accrued by the United States person with respect to such income under section 902 or section 960 exceeds the highest rate of tax specified in section 1 or 11, whichever applies (and with reference to section 15 if applicable), multiplied by the amount of such income (including the amount treated as a dividend under section 78). If, after application of this paragraph (c), income that would otherwise be passive income is determined to be high-taxed income, such income shall be treated as general category income, and any taxes imposed on that income shall be considered related to general category income under § 1.904–6. If, after application of this paragraph (c), passive income is zero or less than zero, any taxes imposed on the passive income shall be considered related to general category income. For additional rules regarding losses related to passive income, see paragraph (c)(2) of this section. Income and taxes shall be translated at the appropriate rates, as determined under sections 986, 987 and 989 and the regulations under those sections, before application of this paragraph (c). For purposes of allocating taxes to groups of income, United States source passive income is treated as any other passive income. In making the determination whether income is high-taxed, however, only foreign source income, as determined under United States tax principles, is relevant. See paragraph (c)(8) *Examples* 10 through 13 of this section for examples illustrating the application of this paragraph (c)(1) and paragraph (c)(2) of this section. This paragraph (c)(1) is applicable for taxable years beginning after March 12, 1999.

(2) *Grouping of items of income in order to determine whether passive income is high-taxed income*

(i) *Grouping rules—Initial allocation and apportionment of deductions and taxes.* For purposes of determining whether passive income is high-taxed, expenses, losses and other deductions shall be allocated and apportioned initially to each of the groups of passive income (described in paragraphs (c)(3), (4), and (5) of this section) under the rules of §§ 1.861–8 through 1.861–14T and 1.865–1 through 1.865–2. Taxpayers that allocate and apportion interest expense on an asset basis may nevertheless apportion passive interest expense among the groups of passive income on a gross income basis. Foreign taxes are allocated to groups under the rules of § 1.904-6(a)(1)(iii). If a loss on a disposition of property gives rise to foreign tax (i.e., the transaction giving rise to the loss is treated under foreign law as having given rise to a gain), the foreign tax shall be allocated to the group of passive income to which gain on the sale would have been assigned under paragraph (c)(3) or (4) of this section. A determination of whether passive income is high-taxed shall be made only after application of paragraph (c)(2)(ii) of this section (if applicable).

(ii) *Reallocation of loss groups.* If, after allocation and apportionment of expenses, losses and other deductions under paragraph (c)(2)(i) of this section, the sum of the allocable deductions exceeds the gross income in one or more groups, the excess deductions shall proportionately reduce income in the other groups (but not below zero).

(3) *Amounts received or accrued by United States persons.* Except as otherwise provided in paragraph (c)(5) of this section, all passive income received by a United States person shall be subject to the rules of this paragraph (c)(3). However, subpart F inclusions that are passive income, dividends from a controlled foreign corporation or noncontrolled section 902 corporation that are passive income, and income that is earned by a United States person through a foreign QBU that is passive income shall be subject to the rules of

this paragraph only to the extent provided in paragraph (c)(4) of this section. For purposes of this section, a foreign QBU is a qualified business unit (as defined in section 989(a)), other than a controlled foreign corporation or noncontrolled section 902 corporation, that has its principal place of business outside the United States. These rules shall apply whether the income is received from a controlled foreign corporation of which the United States person is a United States shareholder, from a noncontrolled section 902 corporation of which the United States person is a domestic corporation meeting the stock ownership requirements of section 902(a), or from any other person. For purposes of determining whether passive income is high-taxed income, the following rules apply:

(i) All passive income received during the taxable year that is subject to a withholding tax of fifteen percent or greater shall be treated as one item of income.

(ii) All passive income received during the taxable year that is subject to a withholding tax of less than fifteen percent (but greater than zero) shall be treated as one item of income.

(iii) All passive income received during the taxable year that is subject to no withholding tax or other foreign tax shall be treated as one item of income.

(iv) All passive income received during the taxable year that is subject to no withholding tax but is subject to a foreign tax other than a withholding tax shall be treated as one item of income.

(4) *Dividends and inclusions from controlled foreign corporations, dividends from noncontrolled section 902 corporations, and income of foreign QBUs.* Except as provided in paragraph (c)(5) of this section, all dividends and all amounts included in gross income of a United States shareholder under section 951(a)(1) with respect to the foreign corporation that (after application of the look-through rules of section 904(d)(3) and §1.904–5) are attributable to passive income received or accrued by a controlled foreign corporation, all dividends from a noncontrolled section 902 corporation that are received or accrued by a domestic corporate shareholder meeting the stock ownership requirements of section 902(a) that (after application of the look-through rules of section 904(d)(4) and §1.904–5) are treated as passive income, and all amounts of passive income received or accrued by a United States person through a foreign QBU shall be subject to the rules of this paragraph (c)(4). This paragraph (c)(4) shall be applied separately to dividends and inclusions with respect to each controlled foreign corporation of which the taxpayer is a United States shareholder and to dividends with respect to each noncontrolled section 902 corporation of which the taxpayer is a domestic corporate shareholder meeting the stock ownership requirements of section 902(a). This paragraph (c)(4) also shall be applied separately to income attributable to each foreign QBU of a controlled foreign corporation, noncontrolled section 902 corporation, or any other look-through entity as defined in §1.904–5(i), except that if the entity subject to the look-through rules is a United States person, then this paragraph (c)(4) shall be applied separately only to each foreign QBU of that United States person.

(i) *Income from sources within the QBU's country of operation.* Passive income from sources within the QBU's country of operation shall be treated as one item of income.

(ii) *Income from sources without the QBU's country of operation.* Passive income from sources without the QBU's country of operation shall be grouped on the basis of the tax imposed on that income as provided in §1.904–4T(c)(3)(i) through (iv).

(iii) *Determination of the source of income.* For purposes of this paragraph (c)(4), income will be determined to be from sources within or without the QBU's country of operation under the laws of the foreign country of the payor of the income.

(5) *Special rules*—(i) *Certain rents and royalties.* All items of rent or royalty income to which an item of rent or royalty expense is directly allocable shall be treated as a single item of income and shall not be grouped with other amounts.

(ii) *Treatment of partnership income.* A partner's distributive share of income

from a foreign or United States partnership that is not subject to the look-through rules and that is treated as passive income under §1.904–5(h)(2)(i) (generally providing that a less than 10 percent partner's distributive share of partnership income is passive income) shall be treated as a single item of income and shall not be grouped with other amounts. A distributive share of income from a foreign partnership that is treated as passive income under the look-through rules shall be grouped according to the rules in paragraph (c)(4) of this section. A distributive share of income from a United States partnership that is treated as passive income under the look-through rules shall be grouped according to the rules in paragraph (c)(3) of this section, except that the portion, if any, of the distributive share of income attributable to income earned by a United States partnership through a foreign QBU shall be grouped under the rules of paragraph (c)(4) of this section.

(iii) *Currency gain or loss*—(A) *Section 986(c)*. Any currency gain or loss with respect to a distribution received by a United States shareholder (other than a foreign QBU of that shareholder) of previously taxed earnings and profits that is recognized under section 986(c) and that is treated as an item of passive income shall be subject to the rules provided in paragraph (c)(3)(iii) of this section. If that item, however, is received or accrued by a foreign QBU of the United States shareholder, it shall be treated as an item of passive income from sources within the QBU's country of operation for purposes of paragraph (c)(4)(i) of this section. This paragraph (c)(5)(iii)(A) shall be applied separately for each foreign QBU of a United States shareholder.

(B) *Section 987(3)*. Any currency gain or loss with respect to remittances or transfers of property between QBUs of a United States shareholder that is recognized under section 987(3)(B) and that is treated as an item of passive income shall be subject to the rules provided in paragraph (c)(3)(iii) of this section. If that item, however, is received or accrued by a foreign QBU of the United States shareholder, it shall be treated as an item of passive income from sources within the QBU's country of operation for purposes of paragraph (c)(4)(i) of this section. This paragraph (c)(5)(iii)(B) shall be applied separately for each foreign QBU of a United States shareholder.

(C) *Example*. The following example illustrates the provisions of this paragraph (c)(5)(iii).

Example. P, a domestic corporation, owns all of the stock of S, a controlled foreign corporation that uses x as its functional currency. In 1993, S earns 100x of passive foreign personal holding company income. When included in P's income under subpart F, the exchange rate is 1x equals $1. Therefore, P's subpart F inclusion is $100. At the end of 1993, S has previously taxed earnings and profits of 100x and P's basis in those earnings is $100. In 1994, S has no earnings and distributes 100x to P. The value of the earnings when distributed is $150. Assume that under section 986(c), P must recognize $50 of passive income attributable to the appreciation of the previously taxed income. Country X does not recognize any gain or loss on the distribution. Therefore, the section 986(c) gain is not subject to any foreign withholding tax or other foreign tax. Thus, under paragraph (c)(3)(iii) of this section, the section 986(c) gain shall be grouped with other items of P's income that are subject to no withholding tax or other foreign tax.

(iv) *Coordination with section 954(b)(4)*. For rules relating to passive income of a controlled foreign corporation that is exempt from subpart F treatment because the income is subject to high foreign tax, see section 904(d)(3)(E), §1.904–4(c)(7)(iii), and §1.904–5(d)(2).

(6) *Application of this paragraph to additional taxes paid or deemed paid in the year of receipt of previously taxed income*—(i) *Determination made in year of inclusion*. The determination of whether an amount included in gross income under section 951(a) is high-taxed income shall be made in the taxable year the income is included in the gross income of the United States shareholder under section 951(a) (hereinafter the ''taxable year of inclusion''). Any increase in foreign taxes paid or accrued, or deemed paid or accrued, when the taxpayer receives an amount that is excluded from gross income under section 959(a) and that is attributable to a controlled foreign corporation's earnings and profits relating to the amount previously included in gross income will not be considered in determining

whether the amount included in income in the taxable year of inclusion is high-taxed income.

(ii) *Exception*. Paragraph (c)(6)(i) of this section shall not apply to an increase in tax in a case in which the taxpayer is required to adjust its foreign taxes in the year of inclusion under section 905(c).

(iii) *Allocation of foreign taxes imposed on distributions of previously taxed income*. If an item of income is considered high-taxed income in the year of inclusion and paragraph (c)(6)(i) of this section applies, then any increase in foreign income taxes imposed with respect to that item shall be considered to be related to general category income. If an item of income is not considered to be high-taxed income in the taxable year of inclusion and paragraph (c)(6)(i) of this section applies, the following rules shall apply. The taxpayer shall treat an increase in taxes paid or accrued, or deemed paid or accrued, on any distribution of the earnings and profits attributable to the amount included in gross income in the taxable year of inclusion as taxes related to passive income to the extent of the excess of the product of (A) the highest rate of tax in section 11 (determined with regard to section 15 and determined as of the year of inclusion) and (B) the amount of the inclusion (after allocation of parent expenses) over (C) the taxes paid or accrued, or deemed paid or accrued, in the year of inclusion. The taxpayer shall treat any taxes paid or accrued, or deemed paid or accrued, on the distribution in excess of this amount as taxes related to general category income. If these additional taxes are not creditable in the year of distribution the carryover rules of section 904(c) apply. For purposes of this paragraph, the foreign tax on a subpart F inclusion shall be considered increased on distribution of the earnings and profits associated with that inclusion if the total of taxes paid and deemed paid on the inclusion and the distribution (taking into account any reductions in tax and any withholding taxes) is greater than the total taxes deemed paid in the year of inclusion. Any foreign currency loss associated with the earnings and profits that are distributed with respect to the inclusion is not to be considered as giving rise to an increase in tax.

(iv) *Increase in taxes paid by successors*—(A) *General rule*. Except as provided in paragraph (c)(6)(iv)(B) of this section, if passive earnings and profits previously included in income of a United States shareholder are distributed to a person that was not a United States shareholder of the distributing corporation in the year the earnings were included, any increase in foreign taxes paid or accrued, or deemed paid or accrued, on that distribution shall be treated as taxes related to general category income, regardless of whether the previously-taxed income was considered high-taxed income under section 904(d)(2)(F) in the year of inclusion.

(B) *Exception*. For a special rule applicable to distributions prior to August 6, 1997, to U.S. shareholders not entitled to look-through treatment, see 26 CFR 1.904–4(c)(6)(iv)(B) (revised as of April 1, 2006).

(C) *Effective date*. This paragraph (c)(6)(iv) applies to taxable years beginning after December 31, 1986. However, for taxable years beginning before January 1, 2001, taxpayers may rely on §1.904–4(c)(6)(iv) of regulations project INTL–1–92, published at 1992–1 C.B. 1209. See §601.601(d)(2) of this chapter.

(7) *Application of this paragraph to certain reductions of tax on distributions of income*—(i) *In general*. If the effective rate of tax imposed by a foreign country on income of a foreign corporation that is included in a taxpayer's gross income is reduced under foreign law on distribution of such income, the rules of this paragraph (c) apply at the time that the income is included in the taxpayer's gross income without regard to the possibility of subsequent reduction of foreign tax on the distribution. If the inclusion is considered to be high-taxed income, then the taxpayer shall treat the inclusion as general category income. When the foreign corporation distributes the earnings and profits to which the inclusion was attributable and the foreign tax on the inclusion is reduced, then the taxpayer shall redetermine whether the inclusion should be considered to be high-taxed income provided that a redetermination of United States tax liability is required

under section 905(c). If, taking into account the reduction in foreign tax, the inclusion would not have been considered high-taxed income, then the taxpayer, in redetermining its United States tax liability for the year or years affected, shall treat the inclusion and the associated taxes (as reduced on the distribution) as passive income and taxes. See section 905(c) and the regulations thereunder regarding the method of adjustment. For this purpose, the foreign tax on a subpart F inclusion shall be considered reduced on distribution of the earnings and profits associated with the inclusion if the total of taxes paid and deemed paid on the inclusion and the distribution (taking into account any reductions in tax and any withholding taxes) is less that the total taxes deemed paid in the year of inclusion. Any foreign currency gain associated with the earnings and profits that are distributed with respect to the inclusion is not to be considered a reduction of tax.

(ii) *Allocation of reductions of foreign tax*. For purposes of paragraph (c)(7)(i) of this section, reductions in foreign tax shall be allocated among the separate categories under the same principles as those of §1.904–6 for allocating taxes among the separate categories. Thus, for purposes of determining to which year's taxes the reduction in taxes relates, foreign law shall apply. If, however, foreign law does not attribute a reduction in taxes to a particular year or years, then the reduction in taxes shall be attributable, on an annual last in-first out (LIFO) basis, to foreign taxes potentially subject to reduction that are associated with previously taxed income, then on a LIFO basis to foreign taxes associated with income that under paragraph (c)(7)(iii) of this section remains as passive income but that was excluded from subpart F income under section 954(b)(4), and finally on a LIFO basis to foreign taxes associated with other earnings and profits. Furthermore, in applying the ordering rules of section 959(c), distributions shall be considered made on a LIFO basis first out of earnings described in section 959(c) (1) and (2), then on a LIFO basis out of earnings and profits associated with income that remains passive income under paragraph (c)(7)(iii) of this section but that was excluded from subpart F under section 954(b)(4), and finally on a LIFO basis out of other earnings and profits. For purposes of this paragraph (c)(7)(ii), foreign law is not considered to attribute a reduction in tax to a particular year or years if foreign law attributes the tax reduction to a pool or group containing income from more than one taxable year and such pool or group is defined based on a characteristic of the income (for example, the rate of tax paid with respect to the income) rather than on the taxable year in which the income is derived.

(iii) *Interaction with section 954(b)(4)*. If the effective rate of tax imposed by a foreign country on income of a foreign corporation is reduced under foreign law on distribution of that income, the rules of section 954(b)(4) shall be applied without regard to the possibility of subsequent reduction of foreign tax. If a taxpayer excludes passive income from a controlled foreign corporation's foreign personal holding company income under these circumstances, then, notwithstanding the general rule of §1.904–5(d)(2), the income shall be considered to be passive income until distribution of that income. At that time, the rules of this paragraph shall apply to determine whether the income is high-taxed income and, therefore, general category income. For purposes of determining whether a reduction in tax is attributable to taxes on income excluded under section 954(b)(4), the rules of paragraph (c)(7)(ii) of this section apply. The rules of paragraph (c)(7)(ii) of this section shall apply for purposes of ordering distributions to determine whether such distributions are out of earnings and profits associated with such excluded income. For an example illustrating the operation of this paragraph (c)(7)(iii), see paragraph (c)(8) *Example (7)* of this section.

(8) *Examples*. The following examples illustrate the application of this paragraph (c).

Example 1. Controlled foreign corporation S is a wholly-owned subsidiary of domestic corporation P. S is a single qualified business unit (QBU) operating in foreign country

X. In 1988, S earns $130 of gross passive royalty income from country X sources, and incurs $30 of expenses that do not include any payments to P. S's $100 of net passive royalty income is subject to $30 of foreign tax, and is included under section 951 in P's gross income for the taxable year. P allocates $50 of expenses to the $100 (consisting of the $70 section 951 inclusion and $30 section 78 amount), resulting in a net inclusion of $50. After application of the high-tax kick-out rules of paragraph (c)(1) of this section, the $50 inclusion is treated as general category income, and the $30 of taxes deemed paid are treated as taxes imposed on general category income, because the foreign taxes paid and deemed paid on the income exceed the highest United States tax rate multiplied by the $50 inclusion ($30>$17 (.34 × $50)).

Example 2. The facts are the same as in *Example* (1) except that instead of earning $130 of gross passive royalty income, S earns $65 of gross passive royalty income from country X sources and $65 of gross passive interest income from country Y sources. S incurs $15 of expenses and $5 of foreign tax with regard to the royalty income and incurs $15 of expenses and $10 of foreign tax with regard to the interest income. P allocates $50 of expenses pro rata to the $50 inclusion ($45 section 951 inclusion and $5 section 78 amount) attributable to the royalty income earned by S and the $50 inclusion ($40 section 951 inclusion and $10 section 78 amount) attributable to the interest income earned by S. Under paragraph (c)(4) of this section, the high-tax test is applied separately to the section 951 inclusion attributable to the income from X sources and the section 951 inclusion attributable to the income from Y sources. Therefore, after allocation of P's $50 of expenses, the resulting $25 inclusion attributable to the royalty income from X sources is still treated as passive income because the foreign taxes paid and deemed paid on the income do not exceed the highest United States tax rate multiplied by the $25 inclusion ($5<$8.50 (.34 × $25)). The $25 inclusion attributable to the interest income from Y sources is treated as general category income because the foreign taxes paid and deemed paid exceed the highest United States tax rate multiplied by the $25 inclusion ($10>$8.50 (.34 × $25)).

Example 3. Controlled foreign corporation S is a wholly-owned subsidiary of domestic corporation P. S is incorporated and operating in country Y and has a branch in country Z. S has two QBUs (QBU Y and QBU Z). In 1988, S earns $65 of gross passive royalty income in country Y through QBU Y and $65 of gross passive royalty income in country Z through QBU Z. S allocates $15 of expenses to the gross passive royalty income earned by each QBU, resulting in net income of $50 in each QBU. Country Y imposes $5 of foreign tax on the royalty income earned in Y, and country Z imposes $10 of tax on royalty income earned in Z. All of S's income constitutes subpart F foreign personal holding company income that is passive income and is included in P's gross income for the taxable year. P allocates $50 of expenses pro rata to the $100 subpart F inclusion attributable to the QBUs (consisting of the $45 section 951 inclusion derived through QBU Y, the $5 section 78 amount attributable to QBU Y, the $40 section 951 inclusion derived through QBU Z, and the $10 section 78 amount attributable to QBU Z), resulting in a net inclusion of $50. Pursuant to paragraph (c)(4) of this section, the high-tax kickout rules must be applied separately to the subpart F inclusion attributable to the income earned by QBU Y and the income earned by QBU Z. After application of the high-tax kickout rules, the $25 inclusion attributable to Y will still be treated as passive income because the foreign taxes paid and deemed paid on the income do not exceed the highest United States tax rate multiplied by the $25 inclusion ($5<$8.50 (.34 × $25)). The $25 inclusion attributable to Z will be treated as general category income because the foreign taxes paid and deemed paid on the income exceed the highest United States tax rate multiplied by the $25 inclusion ($10≤$8.50 (.34 × $25)).

Example 4. Domestic corporation M operates in branch form in foreign countries X and Y. The branches are qualified business units (QBUs), within the meaning of section 989(a). In 1988, QBU X earns passive royalty income, interest income and rental income. All of the QBU X passive income is from Country Z sources. The royalty income is not subject to a withholding tax, and is not taxed by Country X, and the interest and the rental income are subject to a 4 percent and 10 percent withholding tax, respectively. QBU Y earns interest income in Country Y that is not subject to foreign tax. For purposes of determining whether M's foreign source passive income is high-taxed income, the rental income and the interest income earned in QBU X are treated as one item of income pursuant to paragraphs (c) (4)(ii) and (3)(ii) of this section. The interest income earned in QBU Y and the royalty income earned in QBU X are each treated as a separate item of income under paragraphs (c)(4)(i) (with respect to QBU Y's interest income) and (c) (4)(ii) and (3)(iii) (with respect to QBU X's royalty income) of this section.

Example 5. S, a controlled foreign corporation incorporated in foreign country R, is a wholly-owned subsidiary of P, a domestic corporation. For 1988, P is required under section 951(a) to include in gross income $80 (not including the section 78 amount) attributable to the earnings and profits of S for such year, all of which is foreign personal holding company income that is passive rent or royalty income. S does not make any distributions in 1988 or 1989. Foreign income

taxes paid by S for 1988 that are deemed paid by P for such year under section 960(a) with respect to the section 951(a) inclusion equal $20. Twenty dollars ($20) of P's expenses are properly allocated to the section 951(a) inclusion. The foreign income tax paid with respect to the section 951(a) inclusion does not exceed the highest United States tax rate multiplied by the amount of income after allocation of parent expenses ($20<$27.20 (.34 × $80)). Thus, P's section 951(a) inclusion for 1988 is included in P's passive income and the $20 of taxes attributable to that inclusion are treated as taxes related to passive income. In 1990, S distributes $80 to P, and under section 959 that distribution is treated as attributable to the earnings and profits with respect to the amount included in income by P in 1988 and is excluded from P's gross income. Foreign country R imposes a withholding tax of $15 on the distribution in 1990. Under paragraph (c)(6)(i) of this section, the withholding tax in 1990 does not affect the characterization of the 1988 inclusion as passive income nor does it affect the characterization of the $20 of taxes paid in 1988 as taxes paid with respect to passive income. No further parent expenses are allocable to the receipt of that distribution. In 1990, the foreign taxes paid ($15) exceed the product of the highest United States tax rate and the amount of the inclusion reduced by taxes deemed paid in the year of inclusion ($15>((.34 × $80) − $20)). Thus, under paragraph (c)(6)(iii) of this section, $7.20 ((.34 × $80) − $20)) of the $15 withholding tax paid in 1990 is treated as taxes related to passive income and the remaining $7.80 ($15–$7.20) of the withholding tax is treated as related to general category income.

Example 6. S, a controlled foreign corporation, is a wholly-owned subsidiary of P, a domestic corporation. P and S are calendar year taxpayers. In 1987, S's only earnings consist of $200 of passive income that is foreign personal holding company income that is earned in a foreign country X. Under country X's tax system, the corporate tax on particular earnings is reduced on distribution of those earnings and no withholding tax is imposed. In 1987, S pays $100 of foreign tax. P does not elect to exclude this income from subpart F under section 954(b)(4) and includes $200 in gross income ($100 of net foreign personal holding company income and $100 of the section 78 amount). At the time of the inclusion, the income is considered to be high-taxed income under paragraphs (c)(1) and (c)(6)(i) of this section and is general category income to P. S does not distribute any of its earnings in 1987. In 1988, S has no earnings. On December 31, 1988, S distributes the $100 of earnings from 1987. At that time, S receives a $50 refund from X attributable to the reduction of the country X corporate tax imposed on those earnings. Under paragraph (c)(7)(i) of this section, P must redetermine whether the 1987 inclusion should be considered to be high-taxed income. By taking into account the reduction in foreign tax, the inclusion would not have been considered high-taxed income. Therefore, P must redetermine its foreign tax credit for 1987 and treat the inclusion and the taxes associated with the inclusion as passive income and taxes. P must follow the appropriate section 905(c) procedures.

Example 7. The facts are the same as in *Example* 6 except that P elects to apply section 954(b)(4) to S's passive income that is subpart F income. Although the income is not considered to be subpart F income, it remains passive income until distribution. In 1988, S distributes $150 to P. The distribution is a dividend to P because S has $150 of accumulated earnings and profits (the $100 of earnings in 1987 and the $50 refund in 1988). P has no expenses allocable to the dividend from S. In 1988, the income is subject to the high-tax kick-out rules under paragraph (c)(7)(iii) of this section. The income is passive income to P because the foreign taxes paid and deemed paid by P with respect to the income do not exceed the highest United States tax rate on that income.

Example 8. The facts are the same as in *Example* 6 except that the distribution in 1988 is subject to a withholding tax of $25. Under paragraph (c)(7)(i) of this section, P must redetermine whether the 1987 inclusion should be considered to be high-taxed income because there is a net $25 reduction of foreign tax. By taking into account both the reduction in foreign corporate tax and the withholding tax, the inclusion would continue to be considered high-taxed income. P must follow the appropriate section 905(c) procedures. P must redetermine its foreign tax credit for 1987, but the inclusion and the $75 taxes ($50 of deemed paid tax and $25 withholding tax) will continue to be treated as general category income and taxes.

Example 9. (i) S, a controlled foreign corporation operating in country G, is a wholly-owned subsidiary of P, a domestic corporation. P and S are calendar year taxpayers. Country G imposes a tax of 50 percent on S's earnings. Under country G's system, the foreign corporate tax on particular earnings is reduced on distribution of those earnings to 30 percent and no withholding tax is imposed. Under country G's law, distributions are treated as made out of a pool of undistributed earnings subject to the 50 percent tax rate. For 1987, S's only earnings consist of passive income that is foreign personal holding company income that is earned in foreign country G. S has taxable income of $110 for United States purposes and $100 for country G purposes. Country G, therefore, imposes a tax of $50 on the 1987 earnings of S. P does not elect to exclude this income from subpart F under section 954(b)(4) and includes $110 in gross income ($60 of net foreign

personal holding company income and $50 of the section 78 amount). At the time of the inclusion, the income is considered to be high-taxed income under paragraph (c) of this section and is general category income to P. S does not distribute any of its taxable income in 1987.

(ii) In 1988, S earns general category income that is not subpart F income. S again has $110 in taxable income for United States purposes and $100 in taxable income for country G purposes, and S pays $50 of tax to foreign country G. In 1989, S has no taxable income or earnings. On December 31, 1989, S distributes $60 of earnings and receives a refund of foreign tax of $24. Country G treats the distribution of earnings as out of the 50% tax rate pool of earnings accumulated in 1987 and 1988. However, under paragraph (c)(7)(ii) of this section, the distribution, and, therefore, the reduction of tax is treated as first attributable to the $60 of passive earnings attributable to income previously taxed in 1987. However, because, under foreign law, only 40 percent (the reduction in tax rates from 50 percent to 30 percent is a 40 percent reduction in the tax) of the $50 of foreign taxes on the passive earnings can be refunded, $20 of the $24 foreign tax refund reduces foreign taxes on passive earnings. The other $4 of the tax refund reduces the general category taxes from $50 to $46 (even though for United States purposes the $60 distribution is entirely out of passive earnings).

(iii) Under paragraph (c)(7) of this section, P must redetermine whether the 1987 inclusion should be considered to be high-taxed income. By taking into account the reduction in foreign tax, the inclusion would not have been considered high-taxed income ($30<.34 × $110). Therefore, P must redetermine its foreign tax credit for 1987 and treat the inclusion and the taxes associated with the inclusion as passive income and taxes. P must follow the appropriate section 905(c) procedures.

Example 10. P, a domestic corporation, earns $100 of passive royalty income from sources within the United States. Under the laws of Country X, however, that royalty is considered to be from sources within Country X and Country X imposes a 10 percent withholding tax on the payment of the royalty. P also earns $100 of passive foreign source dividend income subject to a 10 percent withholding tax to which $15 of expenses are allocated. In determining whether P's passive income is high-taxed, the $10 withholding tax on P's royalty income is allocated to passive income, and within the passive category to the group of income described in paragraph (c)(3)(ii) of this section (passive income subject to a withholding tax of less than 15 percent (but greater than zero)). For purposes of determining whether the income is high-taxed, however, only the foreign source dividend income is taken into account. The foreign source dividend income will still be treated as passive income because the foreign taxes paid on the passive income in the group ($20) do not exceed the highest United States tax rate multiplied by the $85 of net foreign source income in the group ($20 is less than $28.90 ($100 − $15) × .34).

Example 11. In 2001, *P*, a U.S. citizen with a tax home in Country *X*, earns the following items of gross income: $400 of foreign source, passive limitation interest income not subject to foreign withholding tax but subject to Country *X* income tax of $100, $200 of foreign source, passive limitation royalty income subject to a 5 percent foreign withholding tax (foreign tax paid is $10), $1,300 of foreign source, passive limitation rental income subject to a 25 percent foreign withholding tax (foreign tax paid is $325), $500 of foreign source, general category income that gives rise to a $250 foreign tax, and $2,000 of U.S. source capital gain that is not subject to any foreign tax. *P* has a $900 deduction allocable to its passive rental income. *P*'s only other deduction is a $700 capital loss on the sale of stock that is allocated to foreign source passive limitation income under § 1.865–2(a)(3)(i). The $700 capital loss is initially allocated to the group of passive income subject to no withholding tax but subject to foreign tax other than withholding tax. The $300 amount by which the capital loss exceeds the income in the group must be reapportioned to the other groups under paragraph (c)(2)(ii)(B) of this section. The royalty income is thus reduced by $100 to $100 ($200 − ($300 × (200/600))) and the rental income is thus reduced by $200 to $200 ($400 − ($300 × (400/600))). The $100 royalty income is not high-taxed and remains passive income because the foreign taxes do not exceed the highest United States rate of tax on that income. Under the high-tax kickout, the $200 of rental income and the $325 of associated foreign tax are assigned to the general category category.

Example 12. The facts are the same as in *Example 11* except the amount of the capital loss that is allocated under § 1.865–2(a)(3)(i) and paragraph (c)(2) of this section to the group of foreign source passive income subject to no withholding tax but subject to foreign tax other than withholding tax is $1,200. Under paragraph (c)(2)(ii)(B) of this section, the excess deductions of $800 must be reapportioned to the $200 of net royalty income subject to a 5 percent withholding tax and the $400 of net rental income subject to a 15 percent or greater withholding tax. The income in each of these groups is reduced to zero, and the foreign taxes imposed on the rental and royalty income are considered related to general category income. The remaining loss of $200 constitutes a separate limitation loss with respect to passive income.

Example 13. In 2001, *P*, a domestic corporation, earns a $100 dividend that is foreign

source passive limitation income subject to a 30-percent withholding tax. A foreign tax credit for the withholding tax on the dividend is disallowed under section 901(k). A deduction for the tax is allowed, however, under sections 164 and 901(k)(7). In determining whether *P*'s passive income is high-taxed, the $100 dividend and the $30 deduction are allocated to the first group of income described in paragraph (c)(3)(iv) of this section (passive income subject to no withholding tax or other foreign tax).

(d) [Reserved]

(e) *Financial services income*—(1) *In general*. The term ''financial services income'' means income derived by a financial services entity, as defined in paragraph (e)(3) of this section, that is:

(i) Income derived in the active conduct of a banking, insurance, financing, or similar business (active financing income as defined in paragraph (e)(2) of this section), except income described in paragraph (e)(2)(i)(W) of this section (high withholding tax interest);

(ii) Passive income as defined in section 904(d) (2) (A) and paragraph (b) of this section as determined before the application of the exception for high-taxed income;

(iii) Export financing interest as defined in section 904(d)(2)(G) and paragraph (h) of this section that, but for section 904(d)(2)(B)(ii), would also meet the definition of high withholding tax interest; or

(iv) Incidental income as defined in paragraph (e)(4) of this section.

(2) *Active financing income*—(i) *Income included*. For purposes of paragraph (e)(1) and (e)(3) of this section, income is active financing income only if it is described in any of the following subdivisions.

(A) Income that is of a kind that would be insurance income as defined in section 953(a) (including related party insurance income as defined in section 953(c)(2)) and determined without regard to those provisions of section 953(a)(1)(A) that limit insurance income to income from countries other than the country in which the corporation was created or organized.

(B) Income from the investment by an insurance company of its unearned premiums or reserves ordinary and necessary to the proper conduct of the insurance business, income from providing services as an insurance underwriter, income from insurance brokerage or agency services, and income from loss adjuster and surveyor services.

(C) Income from investing funds in circumstances in which the taxpayer holds itself out as providing a financial service by the acceptance or the investment of such funds, including income from investing deposits of money and income earned investing funds received for the purchase of traveler's checks or face amount certificates.

(D) Income from making personal, mortgage, industrial, or other loans.

(E) Income from purchasing, selling, discounting, or negotiating on a regular basis, notes, drafts, checks, bills of exchange, acceptances, or other evidences of indebtedness.

(F) Income from issuing letters of credit and negotiating drafts drawn thereunder.

(G) Income from providing trust services.

(H) Income from arranging foreign exchange transactions, or engaging in foreign exchange transactions.

(I) Income from purchasing stock, debt obligations, or other securities from an issuer or holder with a view to the public distribution thereof or offering or selling stock, debt obligations, or other securities for an issuer or holder in connection with the public distribution thereof, or participating in any such undertaking.

(J) Income earned by broker-dealers in the ordinary course of business (such as commissions) from the purchase or sale of stock, debt obligations, commodities futures, or other securities or financial instruments and dividend and interest income earned by broker dealers on stock, debt obligations, or other financial instruments that are held for sale.

(K) Service fee income from investment and correspondent banking.

(L) Income from interest rate and currency swaps.

(M) Income from providing fiduciary services.

(N) Income from services with respect to the management of funds.

(O) Bank-to-bank participation income.

(P) Income from providing charge and credit card services or for factoring receivables obtained in the course of providing such services.

(Q) Income from financing purchases from third parties.

(R) Income from gains on the disposition of tangible or intangible personal property or real property that was used in the active financing business (as defined in paragraph (e)(3)(i) of this section) but only to the extent that the property was held to generate or generated active financing income prior to its disposition.

(S) Income from hedging gain with respect to other active financing income.

(T) Income from providing traveller's check services.

(U) Income from servicing mortgages.

(V) Income from a finance lease. For this purpose, a finance lease is any lease that is a direct financing lease or a leveraged lease for accounting purposes and is also a lease for tax purposes.

(W) High withholding tax interest that would otherwise be described as active financing income.

(X) Income from providing investment advisory services, custodial services, agency paying services, collection agency services, and stock transfer agency services.

(Y) Any similar item of income that is disclosed in the manner provided in the instructions to the Form 1118 or 1116 or that is designated as a similar item of income in guidance published by the Internal Revenue Service.

(3) *Financial services entities*—(i) *In general*. The term ''financial services entity'' means an individual or entity that is predominantly engaged in the active conduct of a banking, insurance, financing, or similar business (active financing business) for any taxable Year. Except as provided in paragraph (e)(3)(ii) of this section, a determination of whether an entity is a financial services entity shall be done on an entity-by-entity basis. An individual or entity is predominantly engaged in the active financing business for any year if for that year at least 80 percent of its gross income is income described in paragraph (e)(2)(i) of this section. For this purpose, gross income includes all income realized by an individual or entity, whether includible or excludible from gross income under other operative provisions of the Code, but excludes gain from the disposition of stock of a corporation that prior to the disposition of its stock is related to the transferor within the meaning of section 267(b). For this purpose, income received from a related person that is a financial services entity shall be excluded if such income is characterized under the look-through rules of section 904(d)(3) and §1.904–5. In addition, income received from a related person that is not a financial services entity but that is characterized as financial services income under the look-through rules shall be excluded. *See* paragraph (e)(3)(iv) *Example 5* of this section. Any income received from a related person that is characterized under the look-through rules and that is not otherwise excluded by this paragraph will retain its character either as active financing income or other income in the hands of the recipient for purposes of determining if the recipient is a financial services entity and if the income is financial services income to the recipient. For purposes of this paragraph, related person is defined in §1.904–5(i)(1).

(ii) *Special rule for affiliated groups*. In the case of any corporation that is not a financial services entity under paragraph (e)(3)(i) of this section, but is a member of an affiliated group, such corporation will be deemed to be a financial services entity if the affiliated group as a whole meets the requirements of paragraph (e)(3)(i) of this section. For purposes of this paragraph (e)(3)(ii), affiliated group means an affiliated group as defined in section 1504(a), determined without regard to section 1504(b)(3). In counting the income of the group for purposes of determining whether the group meets the requirements of paragraph (e)(3)(i) of this section, the following rules apply. Only the income of group members that are United States corporations or foreign corporations that are controlled foreign corporations in which United States members of the affiliated group own, directly or indirectly, at least 80 percent of the total voting

power and value of the stock shall be included. For purposes of this paragraph (e)(3)(ii), indirect ownership shall be determined under section 318 and the regulations under that section. The income of the group will not include any income from transactions with other members of the group. Passive income will not be considered to be active financing income merely because that income is earned by a member of the group that is a financial services entity without regard to the rule of this paragraph (e)(3)(ii). This paragraph (e)(3)(ii) applies to taxable years beginning after December 31, 2000.

(iii) *Treatment of partnerships and other pass-through entities* For purposes of determining whether a partner (including a partnership that is a partner in a second partnership) is a financial services entity, all of the partner's income shall be taken into account, except that income that is excluded under paragraph (e)(3)(i) of this section shall not be taken into account. Thus, if a partnership is determined to be a financial services entity none of the income of the partner received from the partnership that is characterized under the look-through rules shall be included for purpose of determining if the partner is a financial services entity. If a partnership is determined not to be a financial services entity, then income of the partner from the partnership that is characterized under the look-through rules will be taken into account (unless such income is financial services income) and such income will retain its character either as active financing income or as other income in the hands of the partner for purposes of determining if the partner is a financial service entity and if the income is financial services income to the partner. If a partnership is a financial services entity and the partner's income from the partnership is characterized as financial services income under the look-through rules, then, for purposes of determining a partner's foreign tax credit limitation, the income from the partnership shall be considered to be financial services income to the partner regardless of whether the partner is itself a financial services entity. The rules of this paragraph (e)(3)(iii) will appIy for purposes of determining whether an owner of an interest in any other pass-through entity the character of the income of which is preserved when such income is included in the income of the owner of the interest is a financial services entity.

(iv) *Examples.* The principles of paragraph (e)(3) of this section are illustrated by the following examples.

Example 1. P is a domestic corporation that owns 100 percent of the stock of S, a controlled foreign corporation incorporated in Country X. For the 1990 taxable year, 60 percent of S's income is active financing income that consists of income that will be considered general limitation or passive income if S is not a financial services entity. The other 40 percent of S's income is passive non-active financing income. S is not a financial services entity and its active financing income thus retains its character as general limitation and passive income. S makes an interest payment to P in 1990 that is characterized under the look-through rules. Although the interest is not financial services income to S under the look-through rules, it retains its character as active financing income when paid to P and P must take that income into account in determining whether it is a financial services entity under paragraph (e)(3)(i) of this section. If P is determined to be a financial services entity, both the portion of the interest payment characterized as active financing income (whether general limitation or passive income in S's hands) and the portion characterized as passive non-active financing income received from S will be recharacterized as financial services income.

Example 2. Foreign corporation A, which is not a controlled foreign corporation, owns 100 percent of the stock of domestic corporation B, which owns 100 percent of the stock of domestic corporation C. A also owns 100 percent of the stock of foreign corporation D. D owns 100 percent of the stock of domestic corporation E, which owns 100 percent of the stock of controlled foreign corporation F. All of the corporations are members of an affiliated group within the meaning of section 1504(a) (determined without regard to section 1504(b)(3)). Pursuant to paragraph (e)(3)(ii) of this section, however, only the income of B, C, E, and F is counted in determining whether the group meets the requirements of paragraph (e)(3)(i) of this section. For the 2001 taxable year, B's income consists of $95 of active financing income and $5 of passive non-active financing income. C has $40 of active financing income and $20 of passive non-active financing income. E has $70 of active financing income and $15 of passive non-active financing income. F has $10

of passive income. B and E qualify as financial services entities under the entity test of paragraph (e)(3)(i) of this section. Therefore, B and E are financial services entities without regard to whether the group as a whole is a financial services entity and all of the income of B and E shall be treated as financial services income. C and F do not qualify as financial services entities under the entity test of paragraph (e)(3)(i) of this section. However, under the affiliated group test of paragraph (e)(3)(ii) of this section, C and F are financial services entities because at least 80 percent of the group's total income consists of active financing income ($205 of active financing income is 80.4 percent of $255 total income). B's and E's passive income is not treated as active financing income for purposes of the affiliated group test of paragraph (e)(3)(ii) of this section even though it is treated as financial services income without regard to whether the group satisfies the affiliated group test. Once C and F are determined to be financial services entities under the affiliated group test, however, all of the passive income of the group is treated as financial services income. Thus, 100 percent of the income of B, C, E, and F for 2001 is financial services income.

Example 3. PS is a domestic partnership operating in branch form in foreign country X. PS has two equal general partners, A and B. A and B are domestic corporations that each operate in branch form in foreign countries Y and Z. All of A's income, except that derived through PS, is manufacturing income. All of B's income, except that derived through PS, is active financing income. A and B's only income from PS are distributive shares of PS's income. PS is a financial services entity and all of its income is financial services income. The income from PS is excluded in determining if A or B are financial services entities. Thus, A is not a financial services entity because none of A's income is active financing income and B is a financial services entity because all of B's income is active financing income. However, both A and B's distributive shares of PS's taxable income consist of financial services income even though A is not a financial services entity.

Example 4. PS is a domestic partnership operating in foreign country X. A and B are domestic corporations that are equal general partners in PS and, therefore, the look-through rules apply for purposes of characterizing A's and B's distributive shares of PS's income. Fifty (50) percent of PS's gross income is active financing income that is not high withholding tax interest. The active financing income includes income that also meets the definition of passive income and income that meets the definition of general limitation income. The other 50 percent of PS's income is from manufacturing. PS is, therefore, not a financial services entity. A s and B's distributive shares of partnership taxable income consist of general limitation manufacturing income and active financing income. Under paragraph (c)(3)(i) of this section, the active financing income shall be financial services income to A or B if either A or B is determined to be a financial services entity. If A or B is not a financial services entity, the distributive shares of income from PS will not be financial services income to A or B and will consist of passive and general limitation income. All of the income from PS is included in determining if A or B are financial services entities.

Example 5. P is a United States corporation that is not a financial services entity. P owns 100 percent of the stock of S, a controlled foreign corporation that is not a financial services entity. S owns 100 percent of the stock of T, a controlled foreign corporation that is a financial services entity. In 1991, T pays a dividend to S. The dividend from T is characterized under the look-through rules of section 904(d)(3). Pursuant to paragraph (e)(3)(i) of this section, the dividend from T is excluded in determining whether S is a financial services entity. S is determined not to be a financial services entity but the dividend retains its character as financial services income in S's hands. Any subpart F inclusion or dividend to P out of earnings and profits attributable to the dividend from T will be excluded in determining whether P is a financial services entity but the inclusion or dividend will retain its character as financial services income.

(4) *Definition of incidental income*—(i) *In general*—(A) *Rule.* Incidental income is income that is integrally related to active financing income of a financial services entity. Such income includes, for example, income from precious metals trading and commodity trading that is integrally related to futures income. If securities, shares of stock, or other types of property are acquired by a financial services entity as an ordinary and necessary incident to the conduct of an active financing business, the income from such property will be considered to be financial services income but only so long as the retention of such property remains an ordinary or necessary incident to the conduct of such business. Thus property, including stock, acquired as the result of, or in order to prevent, a loss in an active financing business upon a loan held by the taxpayer in the ordinary course of such business will be considered ordinary and necessary to the conduct of such business, but income from such property will be considered financial

services income only so long as the holding of such property remains an ordinary and necessary incident to the conduct of such business. If an entity holds such property for five years or less then the property is considered held incident to the financial services business. If an entity holds such property for more than five years, a presumption will be established that the entity is not holding such property incident to its financial services business. An entity will be able to rebut the presumption by demonstrating that under the facts and circumstances it is not holding the property as an investment. However, the fact that an entity holds the property for more than five years and is not able to rebut the presumption that it is not holding the property incident to its financial services business will not affect the characterization of any income received from the property during the first five years as financial services income.

(B) *Examples*. The following examples illustrate the application of paragraph (e)(4)(i) of this section.

Example 1. X is a financial services entity within the meaning of paragraph (e)(3)(i) of this section. In 1987, X made a loan in the ordinary course of its business to an unrelated foreign corporation, Y. As security for that loan, Y pledged certain operating assets. Those assets generate income of a type that would be subject to the general limitation. In January 1989, Y defaulted on the loan and forfeited the collateral. During the period X held the assets, X earned operating income generated by those assets. This income was applied in partial satisfaction of Y's obligation. In 1993, X sold the forfeited assets. The sales proceeds were in excess of the remainder of Y's obligation. The operating income received in the period from 1989 to 1993 and the income on the sale of the assets in 1993 are financial services income of X.

Example 2. The facts are the same as in *Example* 1, except that instead of pledging its operating assets as collateral for the loan, Y pledged the stock of its operating subsidiary Z. In 1993 X sold the stock of Z in complete satisfaction of Y's obligation. X's income from the sale of Z stock in satisfaction of Y's obligation is financial services income.

Example 3. P, a domestic corporation, is a financial services entity within the meaning of paragraph (e)(3)(i) of this section. P holds a United States dollar denominated debt (the ''obligation'') of the Central Bank of foreign country X. The obligation evidences a loan of $100 made by P to the Central Bank. In 1988, pursuant to a program of country X, P delivers the obligation to the Central Bank which credits 70 units of country X currency to M, a country X corporation. M issues all of its only class of capital stock to P. M invests the 70 units of country X currency in the construction and operation of a new hotel in X. In 1994, M distributes 10 units of country X currency to P as a dividend. P is not able to rebut the presumption that it is not holding the stock of M incident to its financial services business. The dividend to P is, therefore, not financial services income.

(ii) *Income that is not incidental income*. Income that is attributable to non-financial activity is not incidental income within the meaning of paragraph (e)(4) (i) and (ii) of this section solely because such income represents a relatively small proportion of the taxpayer's total income or that the taxpayer engages in non-financial activity on a sporadic basis. Thus, for example, income from data processing services provided to related or unrelated parties or income from the sale of goods or non-financial services (for example travel services) is not financial services income, even if the recipient is a financial services entity.

(5) *Exceptions*. Financial services income does not include income that is:

(i) Export financing interest as defined in section 904(d)(2)(G) and paragraph (h) of this section unless that income would be high withholding tax interest as defined in section 904(d)(2)(B) but for paragraph (d)(2)(B)(ii) of that section;

(ii) High withholding tax interest as defined in section 904(d)(2)(B) unless that income also meets the definition of export financing interest; and

(iii) Dividends from noncontrolled section 902 corporations as defined in section 904(d)(2)(E) paid in taxable years beginning before January 1, 2003.

(f)–(g) [Reserved]

(h) *Export financing interest*—(1) *Definitions*—(i) *Export financing interest*. The term ''export financing interest'' means any interest derived from financing the sale (or other disposition) for use or consumption outside the United States of any property that is manufactured, produced, grown, or extracted in the United States by the taxpayer or a related person, and not more than 50 percent of the fair market

value of which is attributable to products imported into the United States. For purposes of this paragraph, the term ''United States'' includes the fifty States, the District of Columbia, and the Commonwealth of Puerto Rico.

(ii) *Fair market value.* For purposes of this paragraph, the fair market value of any property imported into the United States shall be its appraised value, as determined by the Secretary under section 402 of the Tariff Act of 1930 (19 U.S.C. 1401a) in connection with its importation. For purposes of determining the foreign content of an item of property imported into the United States, see section 927 and the regulations thereunder.

(iii) *Related person.* For purposes of this paragraph, the term ''related person'' has the meaning given it by section 954(d)(3) except that such section shall be applied by substituting ''the person with respect to whom the determination is being made'' for ''controlled foreign corporation'' each place it applies.

(2) *Treatment of export financing interest.* Except as provided in paragraph (h)(3) of this section, if a taxpayer (including a financial services entity) receives or accrues export financing interest from an unrelated person, then that interest shall be treated as general category income.

(3) *Exception.* Unless it is received or accrued by a financial services entity, export financing interest shall be treated as passive category income if that income is also related person factoring income. For this purpose, related person factoring income is—

(i) Income received or accrued by a controlled foreign corporation that is income described in section 864(d)(6) (income of a controlled foreign corporation from a loan for the purpose of financing the purchase of inventory property of a related person); or

(ii) Income received or accrued by any person that is income described in section 864(d)(1) (income from a trade receivable acquired from a related person).

(4) *Examples.* The following examples illustrate the operation of paragraph (h)(3) of this section:

Example 1. Controlled foreign corporation S is a wholly-owned subsidiary of domestic corporation P. S is not a financial services entity and has accumulated cash reserves. P has uncollected trade and service receivables of foreign obligors. P sells the receivables at a discount (''factors'') to S. The income derived by S on the receivables is related person factoring income. The income is also export financing interest. Because the income is related person factoring income, the income is passive income to S.

Example 2. Domestic corporation S is a wholly-owned subsidiary of domestic corporation P. S is not a financial services entity and has accumulated cash reserves. P has uncollected trade and service receivables of foreign obligors. P factors the receivables to S. The income derived by S on the receivables is related person factoring income. The income is also export financing interest. The income will be passive income to S.

Example 3. The facts are the same as in *Example* 2except that instead of factoring P's receivables, S finances the sales of P's goods by making loans to the purchasers of P's goods. The interest derived by S on these loans is export financing interest and is not related person factoring income. The income will be general category income to S.

(5) *Income eligible for section 864(d)(7) exception (same country exception) from related person factoring treatment*—(i) *Income other than interest.* If any foreign person receives or accrues income that is described in section 864(d)(7) (income on a trade or service receivable acquired from a related person in the same foreign country as the recipient) and such income would also meet the definition of export financing interest if section 864(d)(1) applied to such income (income on a trade or service receivable acquired from a related person treated as interest), then the income shall be considered to be export financing interest and shall be treated as general category income.

(ii) *Interest income.* If export financing interest is received or accrued by any foreign person and that income would otherwise be treated as related person factoring income under section 864(d)(6) if section 864(d)(7) did not apply, section 904(d)(2)(B)(iii)(I) shall apply, and the interest shall be treated as general category income unless the interest is received or accrued by a financial services entity. If that interest is received or accrued by a financial services entity, section 904(d)(2)(C)(iii)(III) shall apply and the interest shall be treated asgeneral category income.

(iii) *Examples*. The following examples illustrate the operation of this paragraph (h)(5):

Example 1. Controlled foreign corporation S is a wholly-owned subsidiary of domestic corporation P. Controlled foreign corporation T is a wholly-owned subsidiary of controlled foreign corporation S. S and T are incorporated in Country M. In 1987, P sells tractors to T, which T sells to X, an unrelated foreign corporation organized in country M. The tractors are to be used in country M. T uses a substantial part of its assets in its trade or business located in Country M. T has uncollected trade receivables from X that it factors to S. S derived more than 20 percent of its gross income for 1987 other than from an active financing business and the income derived by S from the receivables is not derived in an active financing business. Thus, pursuant to paragraph (e)(3)(i) of this section, S is not a financial services entity. The income is not related person factoring income because it is described in section 864(d)(7) (income eligible for the same country exception). If section 864(d)(1) applied, the income S derived from the receivables would meet the definition of export financing interest. The income, therefore, is considered to be export financing interest and is general category income to S.

Example 2. Controlled foreign corporation S is a wholly-owned subsidiary of domestic corporation, P. Controlled foreign corporation T is a wholly-owned subsidiary of controlled foreign corporation S. S and T are incorporated in country M. S is not a financial services entity. In 1987, P sells tractors to T, which T sells to X, a foreign partnership that is organized in country M and is related to S and T. S makes a loan to X to finance the tractor sales. The interest earned by S from financing the sales is described in section 864(d)(7) and is export financing interest. Therefore, the income shall be general category income to S.

(i) *Interaction of section 907(c) and income described in this section*. If a person receives or accrues income that is income described in section 907(c) (relating to oil and gas income), the rules of section 907(c) and the regulations thereunder, as well as the rules of this section, shall apply to the income. The reduction in amount allowed as foreign tax provided by section 907(a) shall therefore be calculated separately for income in each separate category.

(j) *Special rule for DASTM gain or loss*. Any DASTM gain or loss computed under §1.985–3(d) must be allocated among the categories of income under the rules of §1.985–3 (e)(2)(iv) or (e)(3). The rules of §1.985–3(e) apply before the rules of section 904(d)(2)(B)(iii)(II) (the exception from passive income for high-taxed income).

(k) *Special rule for alternative minimum tax foreign tax credit*. For purposes of computing the alternative minimum tax foreign tax credit under section 59(a), items included in alternative minimum taxable income by reason of section 56(g) (adjustments based on adjusted current earnings) shall be characterized as income described in a separate category under section 904(d) and this section based on the character of the underlying items of income.

(l) *Priority rule*. Income that meets the definitions of a separate category described in paragraph (m) of this section and another category of income described in section 904(d)(2)(A)(i) and (ii) will be subject to the separate limitation described in paragraph (m) of this section and will not be treated as general category income described in section 904(d)(2)(A)(ii).

(m) *Income treated as allocable to an additional separate category*. If section 904(a), (b), and (c) are applied separately to any category of income under the Internal Revenue Code (for example, under section 56(g)(4)(C)(iii)(IV), 245(a)(10), 865(h), 901(j), or 904(h)(10)), that category of income will be treated for all purposes of the Internal Revenue Code and regulations as if it were a separate category listed in section 904(d)(1).

(n) *Effective/applicability dates*. Paragraphs (a), (b), (h)(3), and (l) of this section shall apply to taxable years of United States persons and, for purposes of section 906, foreign persons beginning after December 31, 2006 and ending on or after December 21, 2007, and to taxable years of a foreign corporation which end with or within taxable years of its domestic corporate shareholder beginning after December 31, 2006 and ending on or after December 21, 2007. For purposes of determining whether passive income is high-taxed income, the grouping rules of paragraphs (c)(3) and (4) of this section apply in taxable years ending on or after April 20, 2009. *See* 26 CFR §1.904–4T(c)(3) and (4) (revised as of April 1, 2009) for grouping

rules applicable to taxable years beginning after December 31, 2002, and ending before April 20, 2009. For corresponding rules applicable to taxable years beginning before January 1, 2003, *see* 26 CFR § 1.904–4(c)(2)(i) (revised as of April 1, 2006).

[T.D. 8214, 53 FR 27011, July 18, 1988]

EDITORIAL NOTE: For FEDERAL REGISTER citations affecting § 1.904–4, see the List of CFR Sections Affected, which appears in the Finding Aids section of the printed volume and at *www.fdsys.gov*.

§ 1.904–5 Look-through rules as applied to controlled foreign corporations and other entities.

(a) *Definitions*. For purposes of section 904(d)(3) and (4) and the regulations under section 904, the following definitions apply:

(1) The term *separate category* means, as the context requires, any category of income described in section 904(d)(1)(A) and (B) (or section 904(d)(1)(A), (B), (C), (D), (F), (G), (H), or (I) for taxable years beginning before January 1, 2007) and in § 1.904–4T(b) (or § 1.904–4(e) for taxable years beginning before January 1, 2007), any category of income described in § 1.904–4(m), or any category of earnings and profits to which income described in such provisions is attributable.

(2) The term *controlled foreign corporation* has the meaning given such term by section 957 (taking into account the special rule for certain captive insurance companies contained in section 953(c)).

(3) The term *United States shareholder* has the meaning given such term by section 951(b) (taking into account the special rule for certain captive insurance companies contained in section 953(c)), except that for purposes of this section, a United States shareholder shall include any member of the controlled group of the United States shareholder. For this purpose the controlled group is any member of the affiliated group within the meaning of section 1504(a)(1) except that ''more than 50 percent'' shall be substituted for ''at least 80 percent'' wherever it appears in section 1504(a)(2). For taxable years beginning before January 1, 2001, the preceding sentence shall be applied by substituting ''50 percent'' for ''more than 50 percent''.

(4) The term *noncontrolled section 902 corporation* means any foreign corporation with respect to which the taxpayer meets the stock ownership requirements of section 902(a), or, with respect to a lower-tier foreign corporation, the taxpayer meets the requirements of section 902(b). Except as provided in section 902 and the regulations under that section and paragraphs (i)(3) and (i)(4) of this section, a controlled foreign corporation shall not be treated as a noncontrolled section 902 corporation with respect to any distributions out of its earnings and profits for periods during which it was a controlled foreign corporation. In the case of a partnership owning a foreign corporation, the determination of whether a taxpayer meets the ownership requirements of section 902(a) or (b) will be made with respect to the taxpayer's indirect ownership, and not the partnership's direct ownership, in the foreign corporation. *See* section 902(c)(7).

(b) *In general*. Except as otherwise provided in section 904(d)(3) and (4) and this section, dividends, interest, rents, and royalties received or accrued by a taxpayer from a controlled foreign corporation in which the taxpayer is a United States shareholder shall be treated as general category income. *See* paragraph (c)(4)(iii) of this section for the treatment of dividends received by a domestic corporation from a noncontrolled section 902 corporation in which the domestic corporation meets the stock ownership requirements of section 902(a).

(c) *Rules for specific types of inclusions and payments*—(1) *Subpart F inclusions*—(i) *Rule*. Any amount included in gross income under section 951(a)(1)(A) shall be treated as income in a separate category to the extent the amount so included is attributable to income received or accrued by the controlled foreign corporation that is described as income in such category. For purposes of this § 1.904–5, income shall be characterized under the rules of § 1.904–4 prior to the application of the rules of paragraph (c) of this section. For rules concerning inclusions under section 951(a)(1)(B), see paragraph (c)(4)(i) of this section.

(ii) *Examples*. The following examples illustrate the application of this paragraph (c)(1):

Example 1. Controlled foreign corporation S is a wholly-owned subsidiary of P, a domestic corporation. S earns $200 of net income, $85 of which is foreign base company shipping income, $15 of which is foreign personal holding company income, and $100 of which is non-subpart F general limitation income. No foreign tax is imposed on the income. One hundred dollars ($100) of S's income is subpart F income taxed currently to P under section 951(a)(1)(A). Because $85 of the subpart F inclusion is attributable to shipping income of S, $85 of the subpart F inclusion is shipping income to P. Because $15 of the subpart F inclusion is attributable to passive income of S, $15 of the subpart F inclusion is passive income to P.

Example 2. Controlled foreign corporation S is a wholly-owned subsidiary of domestic corporation P. S is a financial services entity. P manufactures cars and is not a financial services entity. In 1987, S earns $200 of interest income unrelated to its banking business and $900 of interest income related to its banking business. Assume that S pays no foreign taxes and has no expenses. All of S's income is included in P's gross income as foreign personal holding company income. Because S is a financial services entity, income that would otherwise be passive income is considered to be financial services income. P, therefore, treats the entire subpart F inclusion as financial services income.

Example 3. Controlled foreign corporation S is a wholly-owned subsidiary of domestic corporation P. P is a financial services entity. S manufactures cars and is not a financial services entity. In 1987, S earns $200 of passive income that is subpart F income and $900 of general limitation non-subpart F income. Assume that S pays no foreign taxes on its passive earnings and has no expenses. P includes the $200 of subpart F income in gross income. Because P is a financial services entity, the inclusion will be financial services income to P.

Example 4. Controlled foreign corporation S is a wholly-owned subsidiary of domestic corporation P. Neither P nor S is a financial services entity. Controlled foreign corporation T is a wholly-owned subsidiary of controlled foreign corporation S. T is a financial services entity. In 1991, T pays a dividend to S. For purposes of determining whether S is a financial services entity under §1.904–4(e)(3)(i), the dividend from T is ignored. For purposes of characterizing the dividend in S's hands under the look-through rules of paragraph (c)(4) of this section, however, the dividend retains its character as financial services income. Similarly, any subpart F inclusion or dividend to P out of the earnings and profits attributable to the dividend from S is excluded in determining whether P is a financial services entity under §1.904–4(e)(3)(i), but retains its character in P's hands as financial services income under paragraph (c)(4) of this section.

Example 5. Controlled foreign corporation S is a wholly-owned subsidiary of domestic corporation P. S owns 40 percent of foreign corporation A, 45 percent of foreign corporation B, 30 percent of foreign corporation C and 20 percent of foreign corporation D. A, B, C, and D are noncontrolled section 902 corporations. In 1987, S's only income is a $100 dividend from each foreign corporation. Assume that S pays no foreign taxes and has no expenses. All $400 of the income is foreign personal holding company income and is included in P's gross income. P must include $100 in its separate limitation for dividends from A, $100 in its separate limitation for dividends from B, $100 in its separate limitation for dividends from C, and $100 in its separate limitation for dividends from D.

(2) *Interest*—(i) *In general*. For purposes of this paragraph, related person interest is any interest paid or accrued by a controlled foreign corporation to any United States shareholder in that corporation (or to any other related person) to which the look-through rules of section 904(d)(3) and this section apply. Unrelated person interest is all interest other than related person interest. Related person interest shall be treated as income in a separate category to the extent it is allocable to income of the controlled foreign corporation in that category. If related person interest is received or accrued from a controlled foreign corporation by two or more persons, the amount of interest received or accrued by each person that is allocable to any separate category of income shall be determined by multiplying the amount of related person interest allocable to that separate category of income by a fraction. The numerator of the fraction is the amount of related person interest received or accrued by that person and the denominator is the total amount of related person interest paid or accrued by the controlled foreign corporation.

(ii) *Allocating and apportioning expenses of a controlled foreign corporation including interest paid to a related person*. Related person interest and other expenses of a controlled foreign corporation shall be allocated and apportioned in the following manner:

(A) Gross income in each separate category shall be determined;

(B) Any expenses that are definitely related to less than all of gross income as a class, including unrelated person interest that is directly allocated to income from a specific property, shall be allocated and apportioned under the principles of §§ 1.861–8 or 1.861-10T, as applicable, to income in each separate category;

(C) Related person interest shall be allocated to and shall reduce (but not below zero) the amount of passive foreign personal holding company income as determined after the application of paragraph (c)(2)(ii)(B) of this section;

(D) To the extent that related person interest exceeds passive foreign personal holding company income as determined after the application of paragraphs (c)(2)(ii) (B) and (C) of this section, the related person interest shall be apportioned under the rules of this paragraph to separate categories other than passive income.

(*1*) If under § 1.861–9T, the modified gross income method of apportioning interest expense is elected, related person interest shall be apportioned as follows:

$$\text{Related person interest minus Related person interest allocated under paragraph (c)(2)(ii)(C) of this section} \times \frac{\text{Gross income in a separate category (other than passive)}}{\text{Total gross income (other than passive)}}$$

(*2*) If under § 1.861–9T, the asset method of apportioning interest expense is elected, related person interest shall be apportioned according to the following formula:

$$\text{Related person interest minus Related person interest minus allocated under paragraph (c)(2)(ii)(C) of this section} \times \frac{\text{Value of assets in a separate category (other than passive)}}{\text{Value of total assets (other than passive)}}$$

(E) Any other expenses (including unrelated person interest that is not directly allocated to income from a specific property) that are not definitely related expenses or that are definitely related to all of gross income as a class shall be apportioned under the rules of this paragraph to reduce income in each separate category.

(*1*) If under § 1.861–9T, the modified gross income method of apportioning interest expense is elected, the interest expense shall be apportioned as follows:

$$\text{Expense apportionable to a separate category} = \text{Expense} \times \frac{\text{Gross income in a separate category (minus related person interest allocated under paragraph (c)(2)(ii)(C) of this section if the category is passive)}}{\text{Total gross income minus related person interest allocated to passive income under paragraph (c)(2)(ii)(C) of this section}}$$

(*2*) If under § 1.861–9T, the asset method of apportioning interest expense is elected, then the expense shall be apportioned as follows:

$$\text{Expense apportionable to a separate category} = \text{Expense} \times \frac{\text{Value of assets in a separate category (minus related person debt allocated to passive assets if the category is passive)}}{\text{Value of total assets minus related person debt allocated to passive assets}}$$

(*3*) Expenses other than interest shall be apportioned in a similar manner depending on the apportionment method used. *See* § 1.861–8T(c)(1) (i)–(vi).

(iii) *Allocating and apportioning expenses of a noncontrolled section 902 corporation.* Expenses of a noncontrolled section 902 corporation shall be allocated and apportioned in the same manner as expenses of a controlled foreign corporation under paragraph (c)(2)(ii) of this section, except that the related person interest rule of paragraphs (c)(2)(ii)(C) and (D) of this section shall not apply.

(iv) *Definitions*—(A) *Value of assets and reduction in value of assets and gross income.* For purposes of paragraph (c)(2)(ii) (D) and (E) of this section, the value of total assets is the value of assets in all categories (determined under the principles of § 1.861–9T(g)). See § 1.861–10T(d)(2) to determine the reduction in value of assets and gross income for purposes of apportioning additional third person interest expense that is not directly allocated when some interest expense has been directly allocated. For purposes of this paragraph and paragraph (c)(2)(ii)(E) of this section, any reduction in the value of assets for indebtedness that relates to interest allocated under paragraph (c)(2)(ii)(C) of this section is made before determining the average of asset values. For rules relating to the averaging of reduced asset values see § 1.861–9T(g)(2).

(B) *Related person debt allocated to passive assets.* For purposes of paragraph (c)(2)(ii)(E) of this section, related person debt allocated to passive assets is determined as follows:

$$\text{Related person debt allocated to the passive category} = \text{Total related person debt} \times \frac{\text{Related person interest allocable to passive income under paragraph (c)(2)(ii)(C)}}{\text{All related person interest}}$$

For this purpose, the term *total related person debt* means the sum of the principal amounts of obligations of a controlled foreign corporation owed to any United States shareholder of such corporation or to any related entity (within the meaning of paragraph (g) of this section) determined at the end of the taxable year.

(v) *Examples.* The following examples illustrate the operation of this paragraph (c)(2).

Example 1. (i) Controlled foreign corporation S is a wholly-owned subsidiary of P, a domestic corporation. In 1987, S earns $200 of foreign personal holding company income that is passive income. S also earns $100 of foreign base company sales income that is general limitation income. S has $2000 of passive assets and $2000 of general limitation assets. In 1987, S makes a $150 interest payment to P with respect to a $1500 loan from P. S also pays $100 of interest to an unrelated person on a $1000 loan from that person. S

has no other expenses. S uses the asset method to apportion interest expense.

(ii) Under paragraph (c)(2)(ii)(C) of this section, the $150 related person interest payment is allocable to S's passive foreign personal holding company income. Therefore, the $150 interest payment is passive income to P. Because the entire related person interest payment is allocated to passive income under paragraph (c)(2)(ii)(C) of this section, none of the related person interest payment is apportioned to general limitation income under paragraph (c)(2)(ii)(D) of this section. Under paragraph (c)(2)(iii)(B) of this section, the entire amount of the related person debt is allocable to passive assets ($1500 = $1500 × $150/$150). Under paragraph (c)(2)(ii)(E) of this section, $20 of interest expense paid to an unrelated person is apportioned to passive income ($20 = $100 × ($2000 − $1500)/($4000 − $1500)). Eighty dollars ($80) of the interest expense paid to an unrelated person is apportioned to general limitation income ($80 = $100 × $2000/($4000 − $1500)).

Example 2. The facts are the same as in *Example* 1, except that S uses the gross income method to apportion interest expense. Under paragraph (c)(2)(ii)(E) of this section, the unrelated person interest expense would be apportioned on a gross income method. Therefore, $33 of interest expense paid to unrelated persons would be apportioned to passive income ($33 = $100 × ($200 − $150)/($300 − $150) and $67 of interest expense paid to unrelated persons would be apportioned to general limitation income ($67 = $100 × $100/($300 − $150).

Example 3. (i) The facts are the same as in *Example* 1, except that S has an additional $50 of third person interest expense that is directly allocated to income from a specific property that produces only passive income. The principal amount of indebtedness to which the interest relates is $500. S also has $50 of additional non-interest expenses that are not definitely related expenses and that are apportioned on an asset basis.

(ii) Under paragraph (c)(2)(ii)(B) of this section, the $50 of directly allocated third person interest is first allocated to reduce the passive income of S. Under paragraph (c)(2)(ii)(C) of this section, the $150 of related person interest is allocated to the remaining $150 of passive income. Under paragraph (c)(2)(iii)(B) of this section, all of the related person debt is allocated to passive assets. ($1500 = $1500 × $150/$150).

(iii) Under paragraph (c)(2)(ii)(E) of this section, the non-interest expenses that are not definitely related are apportioned on the basis of the asset values reduced by the allocated related person debt. Therefore, $10 of these expenses are apportioned to the passive category ($50 × ($2000 − $1500)/($4000 − $1500)) and $40 are apportioned to the general limitation category ($50 × $2000/($4000 − $1500)).

(iv) In order to apportion third person interest between the categories of assets, the value of assets in a separate category must also be reduced under the principles of § 1.861–8 by the indebtedness relating to the specifically allocated interest. Therefore, under paragraph (c)(2)(iii)(B) of this section, the value of assets in the passive category for purposes of apportioning the additional third person interest = 0 ($2000 minus $500 (the principal amount of the debt, the interest payment on which is directly allocated to specific interest producing properties) minus $1500 (the related person debt allocated to passive assets)). Under paragraph (c)(2)(ii)(E) of this section, all $100 of the non-definitely related third person interest is apportioned to the general limitation category ($100 = $100 × $2000 / ($4000 − $500 − $1500)).

Example 4. (i) Controlled foreign corporation S is a wholly-owned subsidiary of P, a domestic corporation. In 1987, S earns $100 of foreign personal holding company income that is passive income. S also earns $100 of foreign base company sales income that is general limitation income. S has $1000 of general limitation assets and $1000 of passive assets. In 1987, S makes a $150 interest payment to P on a $1500 loan from P and has $20 of general and administrative expenses (G & A) that under the principles of §§ 1.861–8 through 1.861–14T is treated as directly allocable to all of P's gross income. S also makes a $25 interest payment to an unrelated person on a $250 loan from the unrelated person. S has no other expenses. S uses the asset method to apportion interest expense. S uses the gross income method to apportion G & A.

(ii) Under paragraph (c)(2)(ii)(C) of this section, $100 of the interest payment to P is allocable to S's passive foreign personal holding company income. Under paragraph (c)(2)(ii)(D) of this section, the additional $50 of related person interest expense is apportioned to general limitation income ($50 = $50 × $1000/$1000). Under paragraph (c)(2)(iii)(B) of this section, related person debt allocated to passive assets equals $1000 ($1000 = $1500 × $100/$150).

(iii) Under paragraph (c)(2)(ii)(E) of this section, none of the $25 of interest expense paid to an unrelated person is apportioned to passive income ($0 = $25 × ($1000 − $1000)/($2000 − $1000). Twenty-five dollars ($25) of the interest expense paid to an unrelated person is apportioned to general limitation income ($25 = $25 × $1000/($2000 − $1000). Under paragraph (c)(2)(ii)(E) of this section, none of the G & A is allocable to S's passive foreign personal holding company income ($0 = $20 × ($100 − $100)/($200 − $100). All $20 of the G & A is apportioned to S's general limitation income ($20 = $20 × $100/($200 − $100).

Example 5. The facts are the same as in *Example* 4, except that S uses the gross income method to apportion interest expense. As in *Example* 4, $100 of the interest payment to P

is allocate to passive income under paragraph (c)(2)(ii)(C) of this section. Under paragraph (c)(2)(ii)(D) of this section, the additional $50 of related person interest expense is apportioned to general limitation income ($150 − 100 × $100/$100). Under paragraph (c)(2)(ii)(E) of this section, none of the unrelated person interest expense and none of the G & A is apportioned to passive income, because after the application of paragraph (c)(2)(ii)(C) of this section, no passive income remains in the passive income category.

Example 6. Controlled foreign corporation T is a wholly-owned subsidiary of S, a controlled foreign corporation. S is a wholly-owned subsidiary of P, a domestic corporation. S is not a financial services entity. S and T are incorporated in the same country. In 1987, P sells tractors to T, which T sells to X, a foreign corporation that is related to both S and T and is organized in the same country as S and T. S makes a loan to X to finance the tractor sales. Assume that the interest earned by S from financing the sales is export financing interest that is neither related person factoring income nor foreign personal holding company income. The export financing interest earned by S is, therefore, general limitation income. S earns no other income. S makes a $100 interest payment to P. The $100 of interest paid is allocable under the look-through rules of paragraph (c)(2)(ii) of this section to the general limitation income earned by S and is therefore general limitation income to P.

(3) *Rents and Royalties*. Any rents or royalties received or accrued from a controlled foreign corporation in which the taxpayer is a United States shareholder shall be treated as income in a separate category to the extent they are allocable to income of the controlled foreign corporation in that category under the principles of §§ 1.861–8 through 1.861–14T.

(4) *Dividends*—(i) *Look-through rule for controlled foreign corporations*. Any dividend paid or accrued out of the earnings and profits of any controlled foreign corporation, shall be treated as income in a separate category in proportion to the ratio of the portion of earnings and profits attributable to income in such category to the total amount of earnings and profits of the controlled foreign corporation. For purposes of this paragraph, the term ''dividend'' includes any amount included in gross income under section 951(a)(1)(B) as a pro rata share of a controlled foreign corporation's increase in earnings invested in United States property.

(ii) *Special rule for dividends attributable to certain loans*. If a dividend is distributed to a taxpayer by a controlled foreign corporation, that controlled foreign corporation is the recipient of loan proceeds from a related look-through entity (within the meaning of § 1.904–5(i)), and the purpose of such loan is to alter the characterization of the dividend for purposes of this section, then, to the extent of the principal amount of the loan, the dividend shall be characterized with respect to the earnings and profits of the related person lender rather than with respect to the earnings and profits of the dividend payor. A loan will not be considered made for the purpose of altering the characterization of a dividend if the loan would have been made or maintained on substantially the same terms irrespective of the dividend. The determination of whether a loan would have been made or maintained on substantially the same terms irrespective of the dividend will be made taking into account all the facts and circumstances of the relationship between the lender and the borrower. Thus, for example, a loan by a related party lender to a controlled foreign corporation that arises from the sale of inventory in the ordinary course of business will not be considered a loan made for the purpose of altering the character of any dividend paid by the borrower.

(iii) *Look-through rule for dividends from noncontrolled section 902 corporations*. Except as otherwise provided in this paragraph (c)(4)(iii), any dividend that is distributed by a noncontrolled section 902 corporation and received or accrued by a domestic corporation that meets the stock ownership requirements of section 902(a) shall be treated as income in a separate category in proportion to the ratio of the portion of earnings and profits attributable to income in such category to the total amount of earnings and profits of the noncontrolled section 902 corporation. A dividend distributed by a noncontrolled section 902 corporation shall be treated as passive income if the Commissioner determines that the look-through characterization of such dividend cannot reasonably be determined based on the available information, or if such dividend is received or accrued

by a shareholder that is neither a domestic corporation meeting the stock ownership requirements of section 902(a) nor a foreign corporation meeting the requirements of section 902(b). *See* paragraph (i)(4) of this section. *See* §1.904–7 for transition rules concerning the treatment of undistributed earnings (or a deficit) of a noncontrolled section 902 corporation that were accumulated in taxable years beginning before January 1, 2003.

(iv) *Examples*. The following examples illustrate the application of this paragraph (c)(4).

Example 1. Controlled foreign corporation S is a wholly-owned subsidiary of P, a domestic corporation. In 1987, S has earnings and profits of $1,000, $600 of which is attributable to general limitation income and $400 of which is attributable to dividends received by S from its wholly-owned subsidiary, T. T is a controlled foreign corporation and is incorporated and operates in the same country as S. All of T's income is financial services income. Neither S's general limitation income nor the dividend from T is subpart F income. In December 1987, S pays a dividend to P of $200, all of which is attributable to earnings and profits earned in 1987. Six-tenths of the dividend ($120) is treated as general limitation income because six-tenths of S's earnings and profits are attributable to general limitation income. Four-tenths of the dividend ($80) is treated as financial services income because four-tenths of S's earnings and profits are attributable to dividends from T, and all of T's earnings are financial services income.

Example 2. A, a United States person, has been the sole shareholder in controlled foreign corporation X since its organization on January 1, 1963. Both X and A are calendar year taxpayers. X's earnings and profits for 1963 through the end of 1987 totaled $3,000. A sells his stock in X at the end of 1987 and realizes a gain of $4,000. Of the total $4,000 gain, $3,000 (A's share of the post-1962 earnings and profits) is includible in A's gross income as a dividend and is subject to the look-through rules including the transition rule of §1.904–7(a) with respect to the portion of the distribution out of pre-87 earnings and profits. The remaining $1,000 of the gain is includible as gain from the sale or exchange of the X stock and is passive income to A.

(d) *Effect of exclusions from subpart F income*—(1) *De minimis amount of subpart F income*. If the sum of a controlled foreign corporation's gross foreign base company income (determined under section 954(a) without regard to section 954(b)(5)) and gross insurance income (determined under section 953(a)) for the taxable year is less than the lesser of 5 percent of gross income or $1,000,000, then all of that income (other than income that would be financial services income without regard to this paragraph (d)(1)) shall be treated as general limitation income. In addition, if the test in the preceding sentence is satisfied, for purposes of paragraphs (c)(2)(ii) (D) and (E) of this section (apportionment of interest expense to passive income using the asset method), any passive limitation assets shall be treated as general limitation assets. The determination in the first sentence shall be made prior to the application of the exception for certain income subject to a high rate of foreign tax described in paragraph (d)(2) of this section.

(2) *Exception for certain income subject to high foreign tax*. Except as provided in §1.904–4(c)(7)(iii) (relating to reductions in tax upon distribution), for purposes of the dividend look-through rule of paragraph (c)(4)(i) of this section, an item of net income that would otherwise be passive income (after application of the priority rules of §1.904–4(l)) and that is received or accrued by a controlled foreign corporation shall be treated as general limitation income, and the earnings and profits attributable to such income shall be treated as general limitation earnings and profits, if the taxpayer establishes to the satisfaction of the Secretary that such income was subject to an effective rate of income tax imposed by a foreign country greater than 90 percent of the maximum rate of tax specified in section 11 (with reference to section 15, if applicable). The preceding sentence has no effect on amounts (other than dividends) paid or accrued by a controlled foreign corporation to a United States shareholder of such controlled foreign corporation to the extent those amounts are allocable to passive income of the controlled foreign corporation.

(3) *Examples*. The following examples illustrate the application of this paragraph.

Example 1. Controlled foreign corporation S is a wholly-owned subsidiary of P, a domestic corporation. In 1987, S earns $100 of gross

income, $4 of which is interest that is subpart F foreign personal holding company income and $96 of which is gross manufacturing income that is not subpart F income. S has no other earnings for 1987. S has no expenses and pays no foreign taxes. S pays P a $100 dividend. Under the de minimis rule of section 954(b)(3), none of S's income is treated as foreign base company income. All of S's income, therefore, is treated as general limitation income. The entire $100 dividend is general limitation income to P.

Example 2. (i) Controlled foreign corporation S is a wholly-owned subsidiary of P, a domestic corporation. In 1987, S earns $50 of shipping income of a type that is foreign base company shipping income. S also earns $50 of dividends from T, a foreign corporation in which S owns 45 percent of the voting stock, and receives $50 of dividends from U, a foreign corporation in which S owns 5% of the voting stock. Foreign persons hold the remaining voting stock of both T and U. S, T, and U are all incorporated in different foreign countries. The dividends S receives from T and U are of a type that normally would be subpart F foreign personal holding company income that is passive income. Under §1.904–4(l)(1)(iv), however, the dividends from T are dividends from a noncontrolled section 902 corporation rather than passive income. S has no expenses. The earnings and profits of S are equal to the net income after taxes of S. The dividends and the shipping income are taxed abroad by S's country of incorporation at an effective rate of 40 percent. P establishes to the satisfaction of the Secretary that the effective rate of tax on both the dividends and the shipping income exceeds 90 percent of the maximum United States tax rate. Thus, under section 954(b)(4), neither the shipping income nor the dividends are taxed currently to P under subpart F. S's earnings attributable to shipping income and dividends from a noncontrolled section 902 corporation retain their character as such. Under paragraph (d)(2) of this section, S's earnings attributable to the dividends from U are treated as earnings attributable to general limitation income. See §§1.905–3T and 1.905–4T, however, for rules concerning adjustments to the pools of earnings and profits and foreign taxes and redeterminations of United States tax liability when foreign taxes are refunded in a later year.

(ii) In 1988, S has no earnings and pays a $150 dividend (including gross-up) to P. The dividend is paid out of S's post-1986 pool of earnings and profits. One-third of the dividend ($50) is attributable to S's shipping earnings, one-third ($50) is attributable to the dividend from T, and one-third ($50) is attributable to the dividend from U. Pursuant to section 904(d)(3)(E) and paragraph (c)(4) of this section, one-third of the dividend is shipping income, one-third is a dividend from a noncontrolled section 902 corporation, T, and one-third is general limitation income to P.

(e) *Treatment of subpart F income in excess of 70 percent of gross income*—(1) *Rule.* If the sum of a controlled foreign corporation's gross foreign base company income (determined without regard to section 954(b)(5)) and gross insurance income for the taxable year exceeds 70 percent of the gross income, then all of the controlled foreign corporation's gross income shall be treated as foreign base company income (whichever is appropriate) and, thus, included in a United States shareholder's gross income. However, the inclusion in gross income of an amount that would not otherwise be subpart F income does not affect its character for purposes of determining whether the income is within a separate category. The determination of whether the controlled foreign corporation's gross foreign base company income and gross insurance income exceeds 70 percent of gross income is made before the exception for certain income subject to a high rate of foreign tax.

(2) *Example.* The following example illustrates the application of this paragraph.

Example. Controlled foreign corporation S is a wholly-owned subsidiary of P, a domestic corporation. S earns $100, $75 of which is foreign personal holding company income and $25 of which is non-subpart F services income. S is not a financial services entity. S's gross and net income are equal. Under the 70 percent full inclusion rule of section 954(b)(3)(B), the entire $100 is foreign base company income currently taxable to P under section 951. Because $75 of the $100 section 951 inclusion is attributable to S's passive income, $75 of the inclusion is passive income to P. The remaining $25 of the inclusion is treated as general limitation income to P because $25 is attributable to S's general limitation income.

(f) *Modification of look-through rules for certain income*—(1) *High withholding tax interest.* If a taxpayer receives or accrues interest from a controlled foreign corporation that is a financial services entity, and the interest would be described as high withholding tax interest if section 904(d)(3) and paragraph (c)(2) of this section (the look-through rules for interest) did not apply, then the interest shall be treated as high

withholding tax interest to the extent that the interest is allocable under section 904(d)(3) and paragraph (c)(2)(i) of this section to financial services income of the controlled foreign corporation. See section 904(d)(3)(H). The amount treated as high-withholding tax interest under this paragraph (f)(1) shall not exceed the interest, or equivalent income, of the payor that would be taken into account in determining the financial services income of the payor if the look-through rules applied.

(2) *Distributions from a FSC.* Income received or accrued by a taxpayer that, under the rules of paragraph (c)(4) of this section (look-through rules for dividends), would be treated as foreign trade income or as passive income that is interest and carrying charges (as defined in section 927(d)(1)), and that is also a distribution from a FSC (or a former FSC), shall be treated as a distribution from a FSC (or a former FSC).

(3) *Example.* The following example illustrates the operation of paragraph (f)(1) of this section.

Example. Controlled foreign corporation S is a wholly-owned subsidiary of P, a domestic corporation. S is a financial services entity. In 1988, S earns $80 of interest that meets the definition of financial services income and $20 of high withholding tax interest. S makes a $100 interest payment to P. The interest payment to P is subject to a withholding tax of 15 percent. Twenty dollars ($20) of the interest payment to P is considered to be high withholding tax interest because, under section 904(d)(3), it is allocable to the high withholding tax interest earned by S. The remaining eighty dollars ($80) of the interest payment is also treated as high withholding tax interest to P because, under paragraph (f)(1) of this section, interest that is subject to a high withholding tax but would not be considered to be high withholding tax interest under the look-through rules of paragraph (c)(2) of this section, shall be treated as high withholding tax interest to the extent that the interest would have been treated as financial services interest income under the look-through rules of paragraph (c)(2)(i) of this section.

(g) *Application of look-through rules to certain domestic corporations.* The principles of section 904(d)(3) and this section shall apply to any foreign source interest, rents and royalties paid by a United States corporation to a related corporation. For this purpose, a United States corporation and another corporation are considered to be related if one owns, directly or indirectly, stock possessing more than 50 percent of the total voting power of all classes of stock of the other corporation or more than 50 percent of the total value of the other corporation. In addition, a United States corporation and another corporation shall be considered to be related if the same United States shareholders own, directly or indirectly, stock possessing more than 50 percent of the total voting power of all classes of stock or more than 50 percent of the total value of each corporation. For purposes of this paragraph, the constructive stock ownership rules of section 318 and the regulations under that section apply. For taxable years beginning before January 1, 2001, this paragraph (g) shall be applied by substituting ''50 percent or more'' for ''more than 50 percent'' each place it appears.

(h) *Application of look-through rules to partnerships and other pass-through entities*—(1) *General rule.* Except as provided in paragraph (h)(2) of this section, a partner's distributive share of partnership income shall be characterized as income in a separate category to the extent that the distributive share is a share of income earned or accrued by the partnership in such category. Payments to a partner described in section 707 (*e.g.*, payments to a partner not acting in capacity as a partner) shall be characterized as income in a separate category to the extent that the payment is attributable under the principles of §1.861–8 and this section to income earned or accrued by the partnership in such category, if the payments are interest, rents, or royalties that would be characterized under the look-through rules of this section if the partnership were a foreign corporation, and the partner who receives the payment owns 10 percent or more of the value of the partnership. A payment by a partnership to a member of the controlled group (as defined in paragraph (a)(3) of this section) of the partner shall be characterized under the look-through rules of this section if the payment would be a section 707 payment entitled to look-through

treatment if it were made to the partner.

(2) *Exception for certain partnership interests*—(i) *Rule*. Except as otherwise provided, if any limited partner or corporate general partner owns less than 10 percent of the value in a partnership, the partner's distributive share of partnership income from the partnership shall be passive income to the partner, and the partner's distributive share of partnership deductions from the partnership shall be allocated and apportioned under the principles of §1.861–8 only to the partner's passive income from that partnership.

(ii) *Exceptions*. To the extent a partner's distributive share of income from a partnership is a share of high withholding tax interest received or accrued by the partnership, that partner's distributive share of partnership income will be high withholding tax interest regardless of the partner's level of ownership in the partnership. If a partnership interest described in paragraph (h)(2)(i) of this section is held in the ordinary course of a partner's active trade or business, the rules of paragraph (h)(1) of this section shall apply for purposes of characterizing the partner's distributive share of the partnership income. A partnership interest will be considered to be held in the ordinary course of a partner's active trade or business if the partner (or a member of the partner's affiliated group of corporations (within the meaning of section 1504(a) and without regard to section 1504(b)(3))) engages (other than through a less than 10 percent interest in a partnership) in the same or related trade or business as the partnership.

(3) *Income from the sale of a partnership interest*—(i) *In general*. To the extent a partner recognizes gain on the sale of a partnership interest, that income shall be treated as passive category income to the partner, unless the income is considered to be high-taxed under section 904(d)(2)(B)(iii)(II) and §1.904–4(c).

(ii) *Exception for sale by 25-percent owner*. In the case of a sale of an interest in a partnership by a partner that is a 25-percent owner of the partnership, determined by applying section 954(c)(4)(B) and substituting ''controlled foreign corporation'' with ''partner'' every place it appears, for purposes of determining the separate category to which the income recognized on the sale of the partnership interest is assigned such partner shall be treated as selling the proportionate share of the assets of the partnership attributable to such interest.

(4) *Value of a partnership interest*. For purposes of paragraphs (i), (h)(1), and (h)(2) of this section, a partner will be considered as owning 10 percent of the value of a partnership for a particular year if the partner has 10 percent of the capital and profits interest of the partnership. Similarly, a partnership (first partnership) is considered as owning 50 percent of the value of another partnership (second partnership) if the first partnership owns 50 percent of the capital and profits interests of another partnership. For this purpose, value will be determined at the end of the partnership's taxable year. Similarly, a partnership (first partnership) is considered as owning more than 50 percent of the value of another partnership (second partnership) if the first partnership owns more than 50 percent of the capital and profits interests of the second partnership. For this purpose, value will be determined at the end of the partnership's taxable year. For taxable years beginning before January 1, 2001, the second preceding sentence shall be applied by substituting ''50 percent'' for ''more than 50 percent''.

(i) *Application of look-through rules to related entities*—(1) *In general*. Except as provided in paragraphs (i)(2), (3), and (4) of this section, the principles of this section shall apply to distributions and payments that are subject to the look-through rules of section 904(d)(3) and this section from a controlled foreign corporation or other entity otherwise entitled to look-through treatment (a ''look-through entity'') under this section to a related look-through entity. A noncontrolled section 902 corporation shall be considered a look-through entity only to the extent provided in paragraph (i)(4) of this section. Two look-through entities shall be considered to be related to each other if one owns, directly or indirectly, stock possessing more than 50 percent of the

total voting power of all classes of voting stock of the other entity or more than 50 percent of the total value of such entity. In addition, two look-through entities are related if the same United States shareholders own, directly or indirectly, stock possessing more than 50 percent of the total voting power of all voting classes of stock (in the case of a corporation) or more than 50 percent of the total value of each look-through entity. In the case of a corporation, value shall be determined by taking into account all classes of stock. In the case of a partnership, value shall be determined under the rules in paragraph (h)(4) of this section. For purposes of this section, indirect ownership shall be determined under section 318 and the regulations under that section.

(2) *Exception for distributive shares of partnership income.* In the case of tiered partnership arrangements, a distributive share of partnership income will be characterized under the look-through rules of section 904(d)(3) and this section if the partner meets the requirements of paragraph (h)(1) of this section with respect to the partnership (first partnership), whether or not the income is received through another partnership or partnerships (second partnership) and whether or not the first partnership and the second partnership are considered to be related under the rules of paragraph (i)(1) of this section.

(3) *Special rule for dividends between controlled foreign corporations.* Solely for purposes of dividend payments between controlled foreign corporations, two controlled foreign corporations shall be considered related look-through entities if the same United States shareholder owns, directly or indirectly, at least 10 percent of the total voting power of all classes of stock of each foreign corporation. If two controlled foreign corporations are not considered related look-through entities for purposes of this section because a United States shareholder does not satisfy the ownership requirement set forth in this paragraph (i)(3), the dividend payment will be characterized under the look-through rules of section 904(d)(4) and this section if the requirements set forth in paragraph (i)(4) of this section are satisfied.

(4) *Payor and recipient of dividend are members of the same qualified group.* Solely for purposes of dividend payments in taxable years beginning after December 31, 2002, between controlled foreign corporations, noncontrolled section 902 corporations, or a controlled foreign corporation and a noncontrolled section 902 corporation, the payor and recipient corporations shall be considered related look-through entities if the corporations are members of the same qualified group as defined in section 902(b)(2) and the recipient corporation is eligible to compute foreign taxes deemed paid with respect to the dividend under section 902(b)(1).

(5) *Examples.* The following examples illustrate the provisions of this paragraph (i):

Example 1. P, a domestic corporation, owns all of the stock of S, a controlled foreign corporation. S owns 40 percent of the stock of T, a Country X corporation that is a controlled foreign corporation. The remaining 60 percent of the stock of T is owned by V, a domestic corporation. The percentages of value and voting power of T owned by S and V correspond to their percentages of stock ownership. T owns 40 percent (by vote and value) of the stock of U, a Country Z corporation that is a controlled foreign corporation. The remaining 60 percent of U is owned by unrelated U.S. persons. U earns exclusively general limitation non-subpart F income. In 2001, U makes an interest payment of $100 to T. Look-through principles do not apply because T and U are not related look-through entities under paragraph (i)(1) of this section (because T does not own more than 50 percent of the voting power or value of U). The interest is passive income to T, and is subpart F income to P and V. Under paragraph (c)(1) of this section, look-through principles determine P and V's characterization of the subpart F inclusion from T. P and V therefore must characterize the inclusion as passive income.

Example 2. The facts are the same as in *Example 1* except that instead of a $100 interest payment, U pays a $50 dividend to T in 2001. P and V each own, directly or indirectly, more than 10 percent of the voting power of all classes of stock of both T and U. Pursuant to paragraph (i)(3) of this section, for purposes of applying this section to the dividend from U to T, U and T are treated as related look-through entities. Therefore, look-through principles apply to characterize the dividend income as general limitation income to T. The dividend is subpart F income

of T that is taxable to P and V. The subpart F inclusions of P and V are also subject to look-through principles, under paragraph (c)(1) of this section, and are characterized as general limitation income to P and V because the income is general limitation income of T.

Example 3. The facts are the same as in *Example 1*, except that U pays both a $100 interest payment and a $50 dividend to T, and T owns 80 percent (by vote and value) of U. Under paragraph (i)(1) of this section, T and U are related look-through entities, because T owns more than 50 percent (by vote and value) of U. Therefore, look-through principles apply to both the interest and dividend income paid or accrued by U to T, and T treats both types of income as general limitation income. Under paragraph (c)(1) of this section, P and V apply look-through principles to the resulting subpart F inclusions, which therefore are also general limitation income to P and V.

Example 4. P, a domestic corporation, owns all of the voting stock of S, a controlled foreign corporation. S owns 5 percent of the voting stock of T, a controlled foreign corporation. The remaining 95 percent of the stock of T is owned by P. In 2006, T pays a $50 dividend to S and a $950 dividend to P. The dividend to S is not eligible for look-through treatment under paragraph (i)(4) of this section, and S is not eligible to compute an amount of foreign taxes deemed paid with respect to the dividend from T, because S and T are not members of the same qualified group (S owns less than 10 percent of the voting stock of T). See section 902(b) and § 1.902–1(a)(3). However, the dividend is eligible for look-through treatment under paragraph (i)(3) of this section because P owns at least 10 percent of the voting power of all classes of stock of both S and T. The dividend is subpart F income of S that is taxable to P.

Example 5. P, a domestic corporation, owns 50 percent of the voting stock of S, a controlled foreign corporation. S owns 10 percent of the voting stock of T, a controlled foreign corporation. The remaining 50 percent of the stock of S and the remaining 90 percent of the stock of T are owned, respectively, by X and Y. X and Y are each United States shareholders of T but are not related to P, S, or each other. In 2006, T pays a $100 dividend to S. The dividend is not eligible for look-through treatment under paragraph (i)(3) of this section because no United States shareholder owns at least 10 percent of the voting power of all classes of stock of both S and T (P and X each own only 5 percent of T). However, the dividend is eligible for look-through treatment under paragraph (i)(4) of this section, and S is eligible to compute an amount of foreign taxes deemed paid with respect to the dividend from T, because S and T are members of the same qualified group. See section 902(b) and § 1.902–1(a)(3). The dividend is subpart F income of S that is taxable to P and X.

(j) *Look-through rules applied to passive foreign investment company inclusions.* If a passive foreign investment company is a controlled foreign corporation and the taxpayer is a United States shareholder in that passive foreign investment company, any amount included in gross income under section 1293 shall be treated as income in a separate category to the extent the amount so included is attributable to income received or accrued by that controlled foreign corporation that is described as income in the separate category. For purposes of this paragraph (j), the priority rules of § 1.904–4(l) shall apply prior to the application of the rules of this paragraph.

(k) *Ordering rules*—(1) *In general.* Income received or accrued by a related person to which the look-through rules apply is characterized before amounts included from, or paid or distributed by that person and received or accrued by a related person. For purposes of determining the character of income received or accrued by a person from a related person if the payor or another related person also receives or accrues income from the recipient and the look-through rules apply to the income in all cases, the rules of paragraph (k)(2) of this section apply.

(2) *Specific rules.* For purposes of characterizing income under this paragraph, the following types of income are characterized in the order stated:

(i) Rents and royalties;

(ii) Interest;

(iii) Subpart F inclusions and distributive shares of partnership income;

(iv) Dividend distributions.

If an entity is both a recipient and a payor of income described in any one of the categories described in (k)(2) (i) through (iv) of this section, the income received will be characterized before the income that is paid. In addition, the amount of interest paid or accrued, directly or indirectly, by a person to a related person shall be offset against and eliminate any interest received or accrued, directly or indirectly, by a person from that related person before application of the ordering rules of this paragraph. In a case in which a person pays or accrues interest to a related

person, and also receives or accrues interest indirectly from the related person, the smallest interest payment is eliminated and the amount of all other interest payments are reduced by the amount of the smallest interest payment.

(l) *Examples*. The following examples illustrate the application of paragraphs (g), (h), (i), and (k) of this section.

Example 1. S and T, controlled foreign corporations, are wholly-owned subsidiaries of P, a domestic corporation. S and T are incorporated in two different foreign countries and T is a financial services entity. In 1987, S earns $100 of income that is general limitation foreign base company sales income. After expenses, including a $50 interest payment to T, S's income is subject to foreign tax at an effective rate of 40 percent. P elects to exclude S's $50 of net income from subpart F under section 954(b)(4). T earns $350 of income that consists of $300 of subpart F financial services income and $50 of interest received from S. The $50 of interest is foreign personal holding company income in T's hands because section 954(c)(3)(A)(i) (same country exception for interest payments) does not apply. The $50 of interest is also general limitation income to T because S and T are related look-through entities within the meaning of paragraph (i)(1) of this section and, therefore the look-through rules of paragraph (c)(2)(i) of this section apply to characterize the interest payment. Thus, with respect to T, P includes in its gross income $50 of general limitation foreign personal holding company income and $300 of financial services income.

Example 2. The facts are the same as in *Example (1)* except that instead of earning $100 of general limitation foreign base company sales income, S earns $100 of foreign personal holding company income that is passive income. Although the interest payment to T would otherwise be passive income, T is a financial services entity and, under §1.904–4(e)(1), the income is treated as financial services income in T's hands. Thus, P's entire $350 section 951 inclusion consists of financial services income.

Example 3. P, a domestic corporation, wholly-owns S, a domestic corporation that is a 80/20 corporation. In 1987, S's earnings consist of $100 of foreign source shipping income and $100 of foreign source high withholding tax interest. S makes a $100 foreign source interest payment to P. The interest payment to P is subject to the look-through rules of paragraph (c)(2)(i) of this section, and is characterized as shipping income and high withholding tax interest to the extent that it is allocable to such income in S's hands.

Example 4. PS is a domestic partnership that is the sole shareholder of controlled foreign corporation S. PS has two general partners, A and B. A and B each have a greater than 10 percent interest in PS. PS also has two limited partners, C and D. C has a 50 percent interest in the partnership and D has a 9 percent interest. A, B, C and D are all United States persons. In 1987, S has $100 of general limitation non-subpart F income on which it pays no foreign tax. S pays a $100 dividend to PS. The dividend is the only income of PS. Under the look-through rule of paragraph (c)(4) of this section, the dividend to PS is general limitation income. Under paragraph (h)(1) of this section, A's, B's, and C's distributive shares of PS's income are general limitation income. Under paragraph (h)(2) of this section, because D is a limited partner with a less than 10 percent interest in PS, D's distributive share of PS's income is passive income.

Example 5. P has a 25 percent interest in partnership PS that he sells to X for $110. P's basis in his partnership interest is $35. P recognizes $75 of gain on the sale of its partnership interest and is subject to no foreign tax. Under paragraph (h)(3) of this section, the gain is treated as passive income.

Example 6. P, a domestic corporation, owns 100 percent of the stock of S, a controlled foreign corporation, and S owns 100 percent of the stock of T, a controlled foreign corporation. S has $100 of passive foreign personal holding company income from unrelated persons and $100 of general limitation income. S also has $50 of interest income from T. S pays T $100 of interest. Under paragraph (k)(2) of this section, the $100 interest payment from S to T is reduced for limitation purposes to the extent of the $50 interest payment from T to S before application of the rules in paragraph (c)(2)(ii) of this section. Therefore, the interest payment from T to S is disregarded. S is treated as if it paid $50 of interest to T, all of which is allocable to S's passive foreign personal holding company income. Therefore the $50 interest payment from S to T is passive income.

Example 7. P, a domestic corporation, owns 100 percent of the stock of S, a controlled foreign corporation. S owns 100 percent of the stock of T, a controlled foreign corporation and 100 percent of the stock of U, a controlled foreign corporation. In 1988, T pays S $5 of interest, S pays U $10 of interest and U pays T $20 of interest. Under paragraph (k)(2) of this section, the interest payments from S to U must be offset by the amount of interest that S is considered as receiving indirectly from U and the interest payment from U to T is offset by the amount of the interest payment that U is considered as receiving indirectly from T. The $10 payment by S to U is reduced by $5, the amount of the interest payment from T to S that is treated as being paid indirectly by U to S. Similarly, the $20 interest payment from U to T is reduced by $5, the amount of the interest payment from

S to U that is treated as being paid indirectly by T to U. Therefore, under paragraph (k)(2) of this section, T is treated as having made no interest payment to S, S is treated as having paid $5 of interest to U, and U is treated as having paid $15 to T.

Example 8. (i) P, a domestic corporation, owns 100 percent of the stock of S, a controlled foreign corporation, and S owns 100 percent of the stock of T, a controlled foreign corporation. In 1987, S earns $100 of passive foreign personal holding company income and $100 of general limitation non-subpart F sales income from unrelated persons and $100 of general limitation non-subpart F interest income from a related person, W. S pays $150 of interest to T. T earns $200 of general limitation sales income from unrelated persons and the $150 interest payment from S. T pays S $100 of interest.

(ii) Under paragraph (k)(2) of this section, the $100 interest payment from T to S reduces the $150 interest payment from S to T. S is treated as though it paid $50 of interest to T. T is treated as though it made no interest payment to S.

(iii) Under paragraph (k)(2)(ii) of this section, the remaining $50 interest payment from S to T is then characterized. The interest payment is first allocable under the rules of paragraph (c)(2)(ii)(C) of this section to S's passive income. Therefore, the $50 interest payment to T is passive income. The interest income is foreign personal holding company income in T's hands. T, therefore, has $50 of subpart F passive income and $200 of non-subpart F general limitation income.

(iv) Under paragraph (k)(2)(iii) of this section, subpart F inclusions are characterized next. P has a subpart F inclusion with respect to S of $50 that is attributable to passive income of S and is treated as passive income to P. P has a subpart F inclusion with respect to T of $50 that is attributable to passive income of T and is treated as passive income to P.

Example 9. (i) P, a domestic corporation, owns 100 percent of the stock of S, a controlled foreign corporation, and S owns 100 percent of the stock of T, a controlled foreign corporation. P also owns 100 percent of the stock of U, a controlled foreign corporation. In 1987, S earns $100 of passive foreign personal holding company income and $200 of non-subpart F general limitation income from unrelated persons. S also receives $150 of dividend income from T. S pays $100 of interest to T and $100 of interest to U. U earns $300 of non-subpart F general limitation income and the $100 of interest received from S. U pays a $100 royalty to T. T earns the $100 interest payment received from S and the $100 royalty received from U.

(ii) Under paragraph (k)(2)(i) of this section, the royalty paid by U to T is characterized first. Assume that the royalty is directly allocable to U's general limitation income. Also assume that the royalty is not subpart F income to T. With respect to T, the royalty is general limitation income.

(iii) Under paragraph (k)(2)(ii) of this section, the interest payments from S to T and U are characterized next. This characterization is done without regard to any dividend income received by S because, under paragraph (k)(2) of this section, dividends are characterized after interest payments from a related person. The interest payments are first allocable to S's passive income under paragraph (c)(2)(ii)(C) of this section. Therefore, $50 of the interest payment to T is passive and $50 of the interest payment to U is passive. The remaining $50 paid to T is general limitation income and the remaining $50 paid to U is general limitation income. All of the interest payments to T and U are subpart F foreign personal holding company income to both recipients.

(iv) Under paragraph (k)(2)(iii) of this section, P has a $100 subpart F inclusion with respect to T that is characterized next. Fifty dollars ($50) of the subpart F inclusion is passive income to P because it is attributable to the passive income portion of the interest income received by T from S, and $50 of the inclusion is treated as general limitation income to P because it is attributable to the general limitation portion of the interest income received by T from S. Under paragraph (k)(2)(iii) of this section, P also has a $100 subpart F inclusion with respect to U. Fifty dollars ($50) of the subpart F inclusion is passive income to P because it is attributable to the passive portion of the interest income received by U from S, and $50 of the inclusion is general limitation income to P because it is attributable to the general limitation portion of the interest income received by U from S.

(v) Under paragraph (k)(2)(iv) of this section, the $150 distribution from T to S is characterized next. One-hundred dollars ($100) of the distribution is out of earnings and profits attributable to previously taxed income. Therefore, only $50 is a dividend that is subject to the look-through rules of paragraph (d) of this section. The $50 dividend is attributable to T's general limitation income and is general limitation income to S in its entirety.

Example 10. (i) P, a domestic corporation, owns 100 percent of the stock of S, a controlled foreign corporation, and S owns 100 percent of the stock of T, a controlled foreign corporation. P also owns 100 percent of the stock of U, a controlled foreign corporation. S, T and U are all incorporated in the same foreign country. In 1987, S earns $100 of passive foreign personal holding income and $200 of general limitation non-subpart F income from unrelated persons. S pays $100 of interest to T and $100 of interest to U. U earns $300 of general limitation non-subpart F income and the $100 of interest received

from S. T's only income is the $100 interest payment received from S.

(ii) Under paragraph (k)(2)(ii) of this section, the interest payments from S to T and U are characterized first. The interest payments are first allocated under the rule of paragraph (c)(2)(ii)(C) of this section to S's passive income. Therefore, under that provision and paragraph (c)(2)(i) of this section, $50 of the interest payment to T is passive income to T and $50 of the interest payment to U is passive income to U. The remaining $50 paid to T is general limitation income and the remaining $50 paid to U is general limitation income.

(iii) Under paragraph (k)(2)(iii) of this section, any subpart F inclusion of P is determined and characterized next. Under paragraph (c)(1)(i) of this section, paragraphs (c)(2)(i) and (c)(2)(ii) apply not only for purposes of determining the separate category of income of S to which the interest payments from S to T and U are allocable but also for purposes of determining the subpart F income of T and U. Although the interest payments from S to T and U are ''same country'' interest payments that would otherwise be excludible from T's and U's subpart F income under section 954(c)(3)(A)(i), section 954(c)(3)(B) provides that the exception for same country payments between related persons shall not apply to the extent such payments have reduced the subpart F income of the payor. In this case, $50 of the $100 interest payment from S to T reduced S's subpart F income and $50 of the $100 interest payment from S to U reduced the remaining $50 of S's subpart F income. Therefore, T has $50 of subpart F income that is passive income and U has $50 of subpart F income that is passive income. P includes $100 of subpart F income in gross income that is passive income to P.

(iv) The remaining $50 of interest paid by S to T and the remaining $50 of interest paid by S to U is not subpart F income to T or U because it did not reduce S's subpart F income and is therefore eligible for the same country exception.

Example 11. P, a domestic corporation, owns 100 percent of the stock of S, a controlled foreign corporation, and S owns 100 percent of the stock of T, a controlled foreign corporation. P also owns 100 percent of the stock of U, a controlled foreign corporation. In 1991, T earns $100 of general limitation income that is not subpart F income and distributes the entire amount to S as a dividend. S earns $100 of passive foreign personal holding company income and the $100 dividend from T. S pays $100 of interest to U. U earns $200 of general limitation income that is foreign base company income and $100 of interest income from S. This transaction does not involve circular payments and, therefore, the ordering rules of paragraph (k)(2) of this section do not apply. Instead, pursuant to paragraph (k)(1) of this section, income received is characterized first. T's earnings and, thus, the dividend from T to S are characterized first. S includes the $100 dividend from T in gross income as general limitation income because all of T's earnings are general limitation income. S thus has $100 of passive foreign personal holding company income and $100 of general limitation income. The interest payment to U is then characterized as $100 passive income under paragraph (c)(2)(ii)(C) of this section (allocation of related person interest to passive foreign personal holding company income). For 1991, U thus has $200 of general limitation income that is subpart F income, and $100 of passive foreign personal holding company income. For 1991, P includes in its gross income $200 of general limitation subpart F income from U, $100 of passive subpart F income from U (relating to the interest payment from S to U), and $100 of general limitation subpart F income from S (relating to the dividend from T to S).

(m) *Application of section 904(h)*—(1) *In general.* This paragraph (m) applies to certain amounts derived from controlled foreign corporations and noncontrolled section 902 corporations that are treated as United States-owned foreign corporations as defined in section 904(h)(6). For purposes of determining the portion of an interest payment that is allocable to income earned or accrued by a controlled foreign corporation or noncontrolled section 902 corporation from sources within the United States under section 904(h)(3), the rules in paragraph (m)(2) of this section apply. For purposes of determining the portion of a dividend (or amount treated as a dividend, including amounts described in section 951(a)(1)(B)) paid or accrued by a controlled foreign corporation or noncontrolled section 902 corporation that is treated as from sources within the United States under section 904(h)(4), the rules in paragraph (m)(4) of this section apply. For purposes of determining the portion of an amount included in gross income under section 951(a)(1)(A) or 1293 that is attributable to income of the controlled foreign corporation or noncontrolled section 902 corporation from sources within the United States under section 904(h)(2), the rules in paragraph (m)(5) of this section apply. In order to determine whether section 904(h) applies, section 904(h)(5) (exception if a United States-

owned foreign corporation has a *de minimis* amount of United States source income) shall be applied to the total amount of earnings and profits of a controlled foreign corporation or noncontrolled section 902 corporation for a taxable year without regard to the characterization of those earnings under section 904(d).

(2) *Treatment of interest payments.*— (i) *Interest payments from controlled foreign corporations.* If interest is received or accrued by a United States shareholder or a person related to a United States shareholder (within the meaning of paragraph (c)(2)(ii) of this section) from a controlled foreign corporation, the interest shall be considered to be allocable to income of the controlled foreign corporation from sources within the United States for purposes of section 904(d) to the extent that the interest is allocable under paragraph (c)(2)(ii)(C) of this section to passive income that is from sources within the United States. If related person interest is less than or equal to passive income, the related person interest will be allocable to United States source passive income based on the ratio of United States source passive income to total passive income. To the extent that related person interest exceeds passive income, and, therefore, is allocated under paragraph (c)(2)(ii)(D) of this section to income in a separate category other than passive, the following formulas apply in determining the portion of the interest payment that is from sources within the United States. If the taxpayer uses the gross income method to allocate interest, the portion of the interest payment from sources within the United States is determined as follows:

$$\text{The amount of the interest payment allocated to the separate category under paragraph (c)(2)(ii)(D) of this section} \times \frac{\text{Gross income from United States sources in that category}}{\text{Gross income from all sources in that category}}$$

(ii) *Interest payments from noncontrolled section 902 corporations.* If interest is received or accrued by a shareholder from a noncontrolled section 902 corporation (where the shareholder is a domestic corporation that meets the stock ownership requirements of section 902(a)), the rules of paragraph (m)(2)(i) of this section apply in determining the portion of the interest payment that is from sources within the United States, except that the related party interest rules of paragraph (c)(2)(ii)(C) of this section shall not apply.

If the taxpayer uses the asset method to allocate interest, then the portion of the interest payment from sources within the United States is determined as follows:

$$\text{The amount of the interest payment allocated to the separate category under paragraph (c)(2)(ii)(D) of this section} \times \frac{\text{Value of domestic assets in that category}}{\text{Value of total assets in that category}}$$

For purposes of this paragraph, the value of assets in a separate category is the value of assets as determined under the principles of § 1.861–9T(g). See § 1.861–10T(d)(2) for purposes of determining the value of assets and gross income in a separate category as reduced for indebtedness the interest on which is directly allocated.

(3) *Examples.* The following examples illustrate the application of this paragraph.

Example 1. Controlled foreign corporation S is a wholly-owned subsidiary of P, a domestic corporation. In 1988, S pays P $300 of interest. S has no other expenses. In 1988, S has $3000 of assets that generate $650 of foreign source general limitation sales income and a $1000 loan to an unrelated foreign person that generates $20 of foreign source passive interest income. S also has a $4000 loan to an unrelated United States person that generates $70 of United States source passive income and $4000 of inventory that generates $100 of United States source general limitation income. S uses the asset method to allocate interest expense. The following chart summarizes S's assets and income:

	Foreign	U.S.	Totals
Assets:			
Passive	1000	4000	5000
General	3000	4000	7000
Total	4000	8000	12000
Income:			
Passive	20	70	90
General	650	100	750
Total	670	170	840

Under paragraph (c)(2)(ii)(C) of this section, $90 of the related person interest payment is allocable to S's passive income. Under paragraph (m)(2) of this section, $70 is from sources within the United States and $20 is from foreign sources. Under paragraph (c)(2)(ii)(D) of this section, the remaining $210 of the related person interest payment is allocated to general limitation income. Under paragraph (m)(2) of this section, $120 of the remaining $210 is treated as income from sources within the United States ($120 = $210 × $4000/$7000) and $90 is treated as income from foreign sources. ($90 = $210 × $3000/$7000).

Example 2. The facts are the same as in *Example* 1 except that S uses the gross income method to allocate interest expense. The first $90 of related person interest expense is allocated to passive income in the same manner as in Example 1. Under paragraph (c)(2)(ii)(D) of this section, the remaining $210 of the related person interest expense is allocated to general limitation income. Under paragraph (m)(2) of this section, $28 of the remaining $210 is treated as income from United States sources ($28 = $210 × $100/$750) and $182 is treated as income from foreign sources ($182 = $210 × $650/$750).

Example 3. Controlled foreign corporation S is a wholly-owned subsidiary of P, a domestic corporation. In 1988, S pays $300 of interest to P. S has no other expenses. S uses the asset method to allocate interest expense. In 1988, S has $4000 of assets that generate $650 of foreign source general limitation manufacturing income and a $1000 loan to an unrelated foreign person that generates $100 of foreign source passive interest income. S has $500 of shipping assets that generate $200 of foreign source shipping income and $500 of shipping assets that generate $200 of United States source shipping income. S also has a $1000 loan to an unrelated United States person that generates $100 of United States source passive income. S's passive income is not also described as shipping income. The following chart summarizes S's assets and income:

	Foreign	U.S.	Totals
Assets:			
Passive	1000	1000	2000
Shipping	500	500	1000
General	4000	0	4000
Total	5500	1500	7000
Income:			
Passive	100	100	200
Shipping	200	200	400
General	650	0	650
Total	950	300	1250

Under paragraph (c)(2)(ii)(C) of this section, $200 of the related person interest payment is allocable to S's passive income. Under paragraph (m)(2) of this section, $100 of this amount is from foreign sources and $100 is from sources within the United States.

Under paragraph (c)(2)(ii)(D) of this section, $80 of the remaining $100 of the related person interest payment is allocated to general limitation income ($80 = $100 × $4000/$5000) and $20 is allocated to shipping income ($20 = $100 × $1000/$5000).

Under paragraph (m)(2) of this section, none of $80 of the interest payment allocated to general limitation income is treated as income from United States sources ($0 = $80 × $0/$4000). Therefore, the entire $80 is treated as income from foreign sources.

Under paragraph (m)(2) of this section, $10 of the $20 of the interest payment allocated to the shipping income is treated as income from United States sources ($10 = $20 × $500/$1000) and $10 of the $20 is treated as income from foreign sources ($10 = $20 × $500/$1000).

Example 4. The facts are the same as in *Example* 3 except that S uses the gross income method to allocate interest expense. The interest allocated to passive income under paragraph (c)(2)(ii)(C) of this section is the same, $200, $100 from United States sources and $100 from foreign sources.

Under paragraph (c)(2)(ii)(D) of this section, the remaining $100 of related person interest is allocated between the shipping and general limitation categories based on the gross income in those categories. Therefore, $38 of the remaining $100 interest payment is allocated to shipping income ($38 = $100 × $400/($1250 − $200)) and $62 is treated as allocated to general limitation income ($62 = $100 × $650/($1250–$200)).

Under paragraph (m)(2) of this section, $19 of the $38 allocable to shipping income is

treated as income from United States sources ($19 = $38 × $200/$400) and $19 is treated as income from foreign sources ($19 = $38 × $200/$400).

Under paragraph (m)(2) of this section, all of the $62 allocated to general limitation income is treated as income from foreign sources ($62 = $62 × $650/$650).

(4) *Treatment of dividend payments*—(i) *Rule.* Any dividend or distribution treated as a dividend under this section (including an amount included in gross income under section 951(a)(1)(B)) that is received or accrued by a United States shareholder from a controlled foreign corporation, or any dividend that is received or accrued by a domestic corporate shareholder meeting the stock ownership requirements of section 902(a) from a noncontrolled section 902 corporation, shall be treated as income in a separate category derived from sources within the United States in proportion to the ratio of the portion of the earnings and profits of the controlled foreign corporation or noncontrolled section 902 corporation in the corresponding separate category from United States sources to the total amount of earnings and profits of the controlled foreign corporation or noncontrolled section 902 corporation in that separate category.

(ii) *Determination of earnings and profits from United States sources.* In order to determine the portions of earnings and profits from United States sources and from foreign sources within each separate category, related person interest shall be allocated to the United States source portion of income in a separate category by applying the rules of paragraph (m)(2) of this section. Other expenses shall be allocated by applying the rules of paragraph (c)(2)(ii) of this section separately to the United States source income and the foreign source income in each category. For example, unrelated person interest expense that is allocated among categories of income based upon the relative amounts of assets in a category must be allocated between United States and foreign source income within each category by applying the rules of paragraph (c)(2)(ii)(E) of this section separately to United States source and foreign source assets in the separate category.

(iii) *Example.* The following example illustrates the application of this paragraph.

Example. Controlled foreign corporation, S, is a wholly owned subsidiary of P, a domestic corporation. S is a financial services entity. In 1987, S has $100 of non-subpart F general limitation earnings and profits and $100 of non-subpart F financial services income. None of the general limitation earnings and profits are from sources within the United States, and $50 of the financial services earnings and profits are from United States sources. In 1988, S earns $300 of non-subpart F general limitation earnings and profits and $500 of non-subpart F financial services earnings and profits. One hundred dollars ($100) of the general limitation earnings and profits are from sources within the United States. None of the financial services earnings and profits are from United States sources. In 1988, S pays P a $500 dividend. Under paragraph (c)(4) of this section, $200 of the dividend is attributable to general limitation earnings and profits ($200 = $500 × $400/$1000). Under this paragraph (m)(3), the portion of the dividend that is attributable to general limitation earnings and profits from sources within the United States is $50 ($200 × $100/$400). Under paragraph (c)(4) of this section, $300 of the dividend is attributable to financial services earnings and profits ($300 = $500 × $600/$1000). Under this paragraph (m)(3), the portion of the dividend that is attributable to financial services earnings and profits from sources within the United States is $25 ($300 × $50/$600).

(5) *Treatment of inclusions under sections 951(a)(1)(A) and 1293*—(i) *Rule.* Any amount included in the gross income of a United States shareholder of a controlled foreign corporation under section 951(a)(1)(A) or in the gross income of domestic corporate shareholders that meet the stock ownership requirements of section 902(a) with respect to a noncontrolled section 902 corporation that is a qualified electing fund under section 1293 shall be treated as income subject to a separate limitation that is derived from sources within the United States to the extent such amount is attributable to income of the controlled foreign corporation or qualified electing fund, respectively, in the corresponding category of income from sources within the United States. In order to determine a controlled foreign corporation's taxable income and earnings and profits from sources within the United States in each separate category, the principles of paragraph

(m)(4)(ii) of this section shall apply. In order to determine a qualified electing fund's earnings and profits from sources within the United States in each separate category, the principles of paragraph (m)(4)(ii) of this section shall apply, except that the related person interest rule of paragraph (m)(2) of this section shall not apply.

(ii) *Example.* The following example illustrates the application of this paragraph (m)(5).

Example. Controlled foreign corporation S is a wholly-owned subsidiary of domestic corporation, P. In 1987, S earns $100 of subpart F foreign personal holding company income that is passive income. Of this amount, $40 is derived from sources within the United States. S also earns $50 of subpart F general limitation income. None of this income is from sources within the United States. Assume that S pays no foreign taxes and has no expenses. P is required to include $150 in gross income under section 951(a). Of this amount, $60 will be foreign source passive income to P and $40 will be United States source passive income to P. Fifty dollars ($50) will be foreign source general limitation income to P.

(6) *Treatment of section 78 amount.* For purposes of treating taxes deemed paid by a taxpayer under section 902(a) and section 960(a)(1) as a dividend under section 78, taxes that are paid or accrued with respect to United States source income in a separate category shall be treated as United States source income in that separate category.

(7) *Coordination with treaties*—(i) *Rule.* If any amount of income derived from a United States-owned foreign corporation, as defined in section 904(g)(6), would be treated as derived from sources within the United States under section 904(g) and this paragraph (m) and, pursuant to an income tax convention with the United States, the taxpayer chooses to avail itself of benefits of the convention that treat that amount as arising from sources outside the United States under a rule explicitly treating the income as foreign source, then that amount will be treated as foreign source income. However, sections 904 (a), (b), (c), (d) and (f), 902, 907, and 960 shall be applied separately to amounts described in the preceding sentence with respect to each treaty under which the taxpayer has claimed benefits and, within each treaty, to each separate category of income.

(ii) *Example.* The following example illustrates the application of this paragraph (m)(7).

Example. Controlled foreign corporation S is incorporated in Country A and is a wholly-owned subsidiary of P, a domestic corporation. In 1990, S earns $80 of foreign base company sales income in Country A which is general limitation income and $40 of U.S. source interest income. S incurs $20 of expenses attributable to its sales business. S pays P $40 of interest that is allocated to U.S. source passive income under paragraphs (c)(2)(ii)(C) and (m)(2) of this section. Assume that earnings and profits equal net income. All of S's net income of $60 is includible in P's gross income under subpart F (section 951(a)(1)). For 1990, P also has $100 of passive income derived from investments in Country B. Pursuant to section 904(g)(3) and paragraph (m)(2) of this section, the $40 interest payment from S is United States source income to P because it is attributable to United States source interest income of S. The United States-Country A income tax treaty, however, treats all interest payments by residents of Country A as Country A sourced and P elects to apply the treaty. Pursuant to section 904(g)(10) and this paragraph (m)(7), the entire interest payment will be treated as foreign source income to P. P thus has $60 of foreign source general limitation income, $40 of foreign source passive income from S, and $100 of other foreign source passive income. In determining P's foreign tax credit limitation on passive income, the passive income from Country A shall be treated separately from any other passive income.

(n) *Order of application of section 904(d) and (h).* In order to apply the rules of this section, section 904(d)(1) shall first be applied to the controlled foreign corporation or noncontrolled section 902 corporation to determine the amount of income and earnings and profits derived by the controlled foreign corporation or noncontrolled section 902 corporation in each separate category. The income and earnings and profits in each separate category that are from United States sources shall then be determined. Section 904(d)(3), (d)(4), and (h), and this section shall then be applied for purposes of characterizing and sourcing income received, accrued, or included by a United States shareholder in the controlled foreign corporation or a domestic corporate

shareholder that meets the stock ownership requirements of section 902(a) with respect to a noncontrolled section 902 corporation that is attributable or allocable to income or earnings and profits of the foreign corporation.

(o) *Effective dates*—(1) *Rules for controlled foreign corporations and other look-through entities.* Section 904(d)(3) and this section apply to distributions and section 951 inclusions of earnings and profits of a controlled foreign corporation (or other entity to which this section applies) derived during the first taxable year of the controlled foreign corporation (or other entity) beginning after December 31, 1986, and thereafter, and to payments made by a controlled foreign corporation (or other entity) during such taxable years, without regard to whether the corresponding taxable year of the recipient of the distribution or payment or of one or more of the United States shareholders of the controlled foreign corporation begins after December 31, 1986.

(2) *Rules for noncontrolled section 902 corporations.* Paragraphs (a), (a)(1), (a)(4), (b), (c)(2)(iii), (c)(4)(iii), (i)(1), (i)(3), (i)(4), (i)(5), *Examples 4* and *5*, (m)(1), (m)(2)(ii), (m)(4)(i), (m)(5)(i), and (n) of this section apply to distributions from a noncontrolled section 902 corporation that are paid in taxable years of the noncontrolled section 902 corporation ending on or after April 20, 2009. *See* 26 CFR 1.904–5T(a), (a)(1), (a)(4), (b), (c)(2)(iii), (c)(4)(iii), (i)(1), (i)(3), (i)(4), (i)(5), *Examples 4* and *5*, and 26 CFR 1.904–7T(f)(9) (revised as of April 1, 2009) for rules applicable to distributions from a noncontrolled section 902 corporation that are paid in taxable years of the noncontrolled section 902 corporation beginning after December 31, 2002, and ending before April 20, 2009. *See* 26 CFR 1.904–5T(m)(1), (m)(2)(ii), (m)(4)(i), and (n) (revised as of April 1, 2009) for rules applicable to distributions from a noncontrolled section 902 corporation paid in taxable years of such corporation beginning after April 25, 2006, and ending before April 20, 2009. For corresponding rules applicable to taxable years beginning before January 1, 2003, *see* 26 CFR 1.904–5 (revised as of April 1, 2006).

(3) *Rules for income from the sale of a partnership interest.* Paragraph (h)(3) of this section shall apply to taxable years of United States persons and, for purposes of section 906, foreign persons beginning after December 31, 2006 and ending on or after December 21, 2007, and to taxable years of a foreign corporation which end with or within taxable years of its domestic corporate shareholder beginning after December 31, 2006 and ending on or after December 21, 2007.

[T.D. 8214, 53 FR 27020, July 18, 1988]

EDITORIAL NOTE: For FEDERAL REGISTER citations affecting § 1.904–5, see the List of CFR Sections Affected, which appears in the Finding Aids section of the printed volume and at *www.fdsys.gov*.

§ 1.904–6 Allocation and apportionment of taxes.

(a) *Allocation and apportionment of taxes to a separate category or categories of income*—(1) *In general*—(i) *Taxes related to a separate category of income.* The amount of foreign taxes paid or accrued with respect to a separate category of income (including United States source income) shall include only those taxes that are related to income in that separate category. Taxes are related to income if the income is included in the base upon which the tax is imposed. If, for example, foreign law exempts certain types of income from foreign taxes, or certain types of income are exempt from foreign tax under an income tax convention, then no taxes are considered to be related to such income for purposes of this paragraph. As another example, if foreign law provides for a specific rate of tax with respect to certain types of income (*e.g.*, capital gains), or certain expenses, deductions, or credits are allowed under foreign law only with respect to a particular type of income, then such provisions shall be taken into account in determining the amount of foreign tax imposed on such income. A withholding tax (unless it is a withholding tax that is not the final tax payable on the income as described in § 1.904–4(d)) is related to the income from which it is withheld. A tax that is imposed on a base that includes more than one separate category of income is considered to be imposed on income in all such categories, and, thus, the taxes are related to all such categories

included within the foreign country or possession's taxable income base.

(ii) *Apportionment of taxes related to more than one separate category.* If a tax is related to more than one separate category, then, in order to determine the amount of the tax paid or accrued with respect to each separate category, the tax shall be apportioned on an annual basis among the separate categories on the basis of the following formula:

$$\text{Foreign tax related to more than one separate category} \times \frac{\text{Net income subject to that foreign tax included in a separate category}}{\text{Net income subject to that foreign tax}}$$

For purposes of apportioning foreign taxes among the separate categories, gross income is determined under the law of the foreign country or a possession of the United States to which the foreign income taxes have been paid or accrued. Gross income, as determined under foreign law, in the passive category shall first be reduced by any related person interest expense that is allocated to the income under the principles of section 954(b)(5) and § 1.904–5(c)(2)(ii)(C) (adjusted gross passive income). Gross income in all separate categories (including adjusted gross passive income) is next reduced by deducting any expenses, losses, or other amounts that are deductible under foreign law that are specifically allocable to the gross amount of such income under the laws of that foreign country or possession. If expenses are not specifically allocated under foreign law then the expenses will be apportioned under the principles of foreign law but only after taking into account the reduction of passive income by the application of section 954(b)(5). Thus, for example, if foreign law provides that expenses will be apportioned on a gross income basis, the gross income amounts will be those amounts determined under foreign law except that, in the case of passive income, the amount will be adjusted gross passive income. If foreign law does not provide for the direct allocation or apportionment of expenses, losses, or other deductions to a particular category of income, then the principles of §§ 1.861–8 through 1.861–14T and section 954(b)(5) shall apply in allocating and apportioning such expenses, losses, or other deductions to gross income as determined under foreign law after reduction of passive income by the amount of related person interest allocated to passive income under section 954(b)(5) and § 1.904–5(c)(2)(ii)(C). For example, the principles of §§ 1.861–8 through 1.861–14T apply to require definitely related expenses to be directly allocated to particular categories of gross income and provide the methods of apportioning expenses that are definitely related to more than one category of gross income or that are not definitely related to any particular category of gross income. For this purpose, the apportionment of expenses required to be made under §§ 1.861–8 through 1.861–14T need not be made on other than a separate company basis. The rules in this paragraph apply only for purposes of the apportionment of taxes among separate categories of income and do not affect the computation of a taxpayer's foreign tax credit limitation with respect to a specific category of income. If the taxpayer applies the principles of §§ 1.861–8 through 1.861–14T for purposes of allocating expenses at the level of the taxpayer (or at the level of the qualified business unit, foreign subsidiary, or other entity that paid or accrued the foreign taxes) under this paragraph (a)(1)(ii), such principles shall be applied (for such purposes) in the same manner as the taxpayer applies such principles in determining the income or earnings and profits for United States tax purposes of the taxpayer (or of the qualified business unit, foreign subsidiary, or other entity that paid or accrued the foreign taxes, as

the case may be). For example, a taxpayer must use the modified gross income method under §1.861–9T when applying the principles of that section for purposes of this paragraph (a)(1)(ii) to determine the amount of a controlled foreign corporation's income, in each separate category, that is taxed by a foreign country, if the taxpayer applies the modified gross income method under §1.861–9T(f)(3) when applying §1.861–9T to determine the income and earnings and profits of the controlled foreign corporation for United States tax purposes.

(iii) *Apportionment of taxes for purposes of applying the high-tax income test.* If taxes have been allocated and apportioned to passive income under the rules of paragraph (a)(1) (i) or (ii) of this section, the taxes must further be apportioned to the groups of income described in §1.904–4(c) (3), (4) and (5) for purposes of determining if the group is high-taxed income. Taxes will be related to income in a particular group under the same rules as those in paragraph (a)(1) (i) and (ii) of this section except that those rules shall be applied by substituting the term ''group'' for the term ''category.''

(iv) *Special rule for base and timing differences.* If, under the law of a foreign country or possession of the United States, a tax is imposed on an item of income that does not constitute income under United States tax principles, that tax shall be treated as imposed with respect to general limitation income. If, under the law of a foreign country or possession of the United States, a tax is imposed on an item that would be income under United States tax principles in another year, that tax will be allocated to the appropriate separate category or categories as if the income were recognized under United States tax principles in the year in which the tax was imposed.

(2) [Reserved]

(b) *Application of paragraph (a) to sections 902 and 960*—(1) *Determination of foreign taxes deemed paid.* If, for the taxable year, there is included in the gross income of a domestic corporation under section 951 an amount attributable to the earnings and profits of a controlled foreign corporation for any taxable year and the amount included consists of income in more than one separate category of the controlled foreign corporation, then the domestic corporation shall be deemed to have paid only a portion of the taxes paid or accrued, or deemed paid or accrued, by the controlled foreign corporation that are allocated to each separate category to which the inclusion is attributable. The portion of the taxes allocated to a particular separate category that shall be deemed paid by the United States shareholder shall be equal to the taxes allocated to that separate category multiplied by the amount of the inclusion with respect to that category (as determined under §1.904–5(c)(1)) and divided by the earnings and profits of the controlled foreign corporation with respect to that separate category (in accordance with §1.904–5(c)(2)(ii)). The rules of this paragraph (b)(1) also apply for purposes of computing the foreign taxes deemed paid by United States shareholders of controlled foreign corporations under section 902.

(2) *Distributions received from foreign corporations that are excluded from gross income under section 959(b).* The principles of this paragraph shall be applied to—

(i) Any portion of a distribution received from a first-tier corporation by a domestic corporation or individual that is excluded from the domestic corporation's or individual's income under section 959(a) and §1.959–1; and

(ii) Any portion of a distribution received from an immediately lower-tier corporation by a second- or first-tier corporation that is excluded from such foreign corporation's gross income under section 959(b) and §1.959–2, if such distribution is treated as a dividend pursuant to §1.960–2(a).

(3) *Application of section 78.* For purposes of treating taxes deemed paid by a taxpayer under section 902(a) and section 960(a)(1) as a dividend under section 78, taxes that were allocated to income in a separate category shall be treated as income in that same separate category.

(4) *Increase in limitation.* The amount of the increase in the foreign tax credit limitation allowed by section 960(b) and §1.960–4 shall be determined with

regard to the applicable category of income under section 904(d).

(c) *Examples*. The following examples illustrate the application of this section.

Example 1. M, a domestic corporation, conducts business in foreign country X. M earns $400 of shipping income, $200 of general limitation income and $200 of passive income as determined under foreign law. Under foreign law, none of M's expenses are directly allocated or apportioned to a particular category of income. Under the principles of §§ 1.861–8 through 1.861–14T, M apportions $75 of directly allocable expenses to shipping income, $10 of directly allocable expenses to general limitation income, and no such expenses to passive income. M also apportions expenses that are not directly allocable to a specific class of gross income—$40 to shipping income, $20 to general limitation income, and $20 to passive income. Therefore, for purposes of paragraph (a) of this section, M has $285 of net shipping income, $170 of net general limitation income, and $180 of net passive income. Country X imposes tax of $100 on a base that includes M's shipping income and general limitation income. Country X exempts passive income from tax. The tax paid by M is related to M's shipping and general limitation income. The $100 tax is apportioned between those limitations. Thus, M is considered to have paid $63 of X tax on its shipping income ($100 × $285/$455) and $37 of tax on its general limitation income ($100 × $170/$455). None of the X tax is allocated to M's passive income.

Example 2. The facts are the same as in example 1 except that X does not exempt all passive income from tax but only exempts interest income. M's passive income consists of $100 of gross dividend income, to which $10 of expenses that are not directly allocable are apportioned, and $100 of interest income, to which $10 of expenses that are not directly allocable are apportioned. The $90 of net dividend income is subject to X tax, and $90 of net interest income is exempt from X tax. M pays $130 of tax to X. The $130 of tax is related to M's general, shipping, and passive income. The tax is apportioned among those limitations as follows: $68 to shipping income ($130 × $285/$545) $41 to general limitation income ($130 × $170/$545), and $21 to passive income ($130 × $90/$545).

Example 3. P, a domestic corporation, owns 100 percent of S, a controlled foreign corporation organized in country X. S owns 100 percent of T, a controlled foreign corporation that is also organized in country X. Country X grants group relief to S and T. In 1987, S earns $100 of income and T incurs an $80 loss. Under country X's group relief provisions, only $20 of S's income is subject to country X tax. Country X imposes a 30 percent tax on this income ($6). P includes $100 of S's income in gross income under section 951. Six dollars ($6) of foreign tax is related to that income for purposes of section 960.

Example 4. P, a domestic corporation, owns 100 percent of S, a controlled foreign corporation organized in country X and 100 percent of T, a controlled foreign corporation organized in country Y. T has $200 of gross manufacturing general limitation income and $50 of passive income. T also pays S $100 for shipping T's goods, a price that may be justified under section 482. T has no other expenses and S has no other income or expense. T's income and earnings and profits are the same. Foreign country X does not tax S on its shipping income. Foreign country Y taxes all of T's income at a rate of 20 percent. Under the law of foreign country Y, T is only allowed a $50 deduction for the payment to S. Therefore, for foreign law purposes, T has $150 of manufacturing income and earnings and profits and $50 of passive income and earnings and profits upon which it pays $40 of tax. Under the principles of foreign law, $30 of that tax is imposed on the general limitation manufacturing income and $10 of the tax is imposed on passive income. Therefore, the foreign effective rate on the general limitation income is 30 percent and the foreign effective rate on the passive income is 20 percent. T has $100 of general limitation income and $50 of passive income and pays $30 of general limitation taxes and $10 of passive taxes. S has $100 of shipping income and pays no foreign tax.

Example 5. R, a domestic corporation, owns 50 percent of T, a foreign corporation that is not a controlled foreign corporation and that is organized in foreign country X. R licenses certain property to T. T then relicenses this property to a third person. In 1987, T paid R a royalty of $100 all of which is treated as passive income to R because it was not an active royalty as defined in § 1.904–4(b)(2). R has $10 of expenses associated with the royalty income and no foreign tax was imposed on the royalty so the high-tax kickout does not apply. In 1988, the Commissioner determined that the correct arm's length royalty was $150 and under the authority of section 482 reallocated an additional $50 of income to R for 1987. Under a closing agreement with the Commissioner, R elected the benefits of Rev. Proc. 65–17 in relation to the income reallocated from R and established an account receivable from T. In 1988, T paid R an additional $50 to reflect the section 482 adjustment and the account receivable that was established because of the adjustment. Foreign country X treats the $50 payment in 1988 as a dividend by T and imposes a $10 withholding tax on the payment. Under paragraph (a)(1) of this section, the $10 of withholding tax is treated as fully allocable to the $50 payment because under foreign law the tax is imposed only on that income. For

U.S. purposes, the income is not characterized as a dividend but as a repayment of a bona fide debt and, therefore, the $50 of income is not required to be recognized by R in 1988. The $10 of tax is treated as a tax paid in 1988 on the $50 of passive income included by R in 1987 pursuant to the section 482 adjustment rather than as a tax associated with a dividend from a noncontrolled section 902 corporation. The $10 tax is a tax imposed on passive income under paragraph (a)(1)(iv) of this section.

Example 6. P, a domestic corporation, owns all of the stock of S, a controlled foreign corporation that is incorporated in country X. In 2004, S has $100 of passive income, $200 of shipping income and $200 of general limitation income. S also has $100 of related person interest expense and $100 of other expenses that under foreign law are directly allocable to the general limitation income of S. S has no other expenses. Country X imposes a tax of 25 percent on all of the net income of S and S, therefore, pays $75 in foreign tax. Under paragraph (a)(1)(ii) of this section, the passive income of S is first reduced by the amount of related person interest for purposes of determining the net amount for purposes of allocating the $75 of tax. Under paragraph (a)(1)(ii) of this section, the general limitation income of S is reduced by the $100 of other expenses. Therefore, $50 of the foreign tax is allocated to the shipping income of S ($50 = $75 × $200/$300), $25 is allocated to the general limitation income of S ($25 = $75 × $100/$300), and no taxes are allocated to S's passive income.

Example 7. Domestic corporation P owns all of the stock of controlled foreign corporation S, which owns all of the stock of controlled foreign corporation T. All such corporations use the calendar year as the taxable year. Assume that earnings and profits are equal to net income and that the income amounts are identical under United States and foreign law principles. In 1987, T earns (before foreign taxes) $187.50 of net passive income and $62.50 of net general limitation income and pays $50 of foreign taxes. S earns no income in 1987 and pays no foreign taxes. For 1987, P is required under section 951 to include in gross income $175 attributable to the earnings and profits of T for that year. One hundred and fifty dollars ($150) of the subpart F inclusion is attributable to passive income earned by T, and $25 of the subpart F inclusion is attributable to general limitation income earned by T. In 1988, T earns no income and pays no foreign taxes. T pays a $200 dividend to S, consisting of $175 from its earnings and profits attributable to amounts required to be included in P's gross income with respect to T and $25 from its other earnings and profits. Assume that no withholding tax is imposed with respect to the distribution from T to S. In 1988, S earns $100 of net general limitation income and receives a $200 dividend from T. S pays $30 in foreign taxes. For 1988, P is required under section 951 to include in gross income $22.50 attributable to the earnings and profits of S for such year. The entire subpart F inclusion is attributable to general limitation income earned by S. In 1988, S pays P a dividend of $247.50, consisting of $157.50 from its earnings and profits attributable to the amount required under section 951 to be included in P's gross income with respect to T, $22.50 from its earnings and profits attributable to the amount required under section 951 to be included in P's gross income with respect to S, and $67.50 from its other earnings and profits. Assume the de minimis rule of section 954(b)(3)(A) and the full inclusion rule of section 954(b)(3)(B) do not apply to the gross amounts of income earned by S and T. The foreign income taxes deemed paid by P for 1987 and 1988 under section 960(a)(1) and section 902(a) are determined as follows on the basis of the following facts and computations.

T corporation (second-tier corporation):			
1. Pre-tax earnings and profits:			
(a) Passive income (p.i.)	187.50		
Plus:			
(b) General limitation income (g.l.i.)	62.50		
(c) Total	250.00		
Less:			
(d) Foreign income taxes paid on or with respect to T's earnings and profits (20%)		50.00	
(e) Earnings and profits			200.00
2. Allocation of taxes:			
(a) Foreign income taxes paid by T that are allocable to p.i. earned by T:			
Line 1(d) taxes		50.00	
Multiplied by: foreign law net p.i.		187.50	
Divided by: foreign law total net income		250.00	
Result			37.50
(b) Foreign income taxes paid by T that are allocable to g.l.i. earned by T:			
Line 1(d) taxes		50.00	
Multiplied by: foreign law net g.l.i.		62.50	
Divided by: foreign law total net income		250.00	
Result			12.50
3. T's earnings and profits:			
(a) Earnings and profits attributable to T's p.i.:			
Line (1)(a) e & p		187.50	
Less: line 2(a) taxes		37.50	
Result			150.00
(b) Earnings and profits attributable to T's g.l.i.:			
Line (1)(b) e & p		62.50	

Less: line 2(b) taxes		12.50	
Result			50.00
4. Subpart F inclusion attributable to T:			
(a) Amount required to be included in P's gross income for 1987 under section 951 with respect to T that is attributable to T's p.i.			150.00
(b) Amount required to be included in P's gross income for 1987 under section 951 with respect to T that is attributable to T's g.l.i.			25.00
5. Foreign income taxes deemed paid by P under section 960(a)(1) with respect to T:			
(a) Taxes deemed paid that are attributable to T's subpart F inclusion that are attributable to T's p.i.:			
Line 2(a) taxes		37.50	
Multiplied by: line 4(a) sec. 951 incl.		150.00	
Divided by: line 3(a) e & p		150.00	
Result:			37.50
(b) Taxes deemed paid that are attributable to T's subpart F inclusion that are attributable to T's g.l.i.:			
Line 2(b) taxes		12.50	
Multiplied by: line 4(b) sec. 951 incl.		25.00	
Divided by: line 3(b) e & p		50.00	
Result			6.25
6. Dividends paid to S:			
(a) Dividends attributable to T's previously taxed p.i.		150.00	
Plus:			
(b) Dividends attributable to T's previously taxed g.l.i.		25.00	
Plus:			
(c) Dividends from T's non-previously taxed earnings and profits attributable to p.i.		0	
Plus:			
(d) Dividends from T's non-previously taxed earnings and profits attributable to g.l.i.			25.00
(e) Total dividends paid to S			200.00
7. Taxes deemed paid by S:			
(a) Taxes of T deemed paid by S for 1987 under section 902(b)(1) with regard to T's p.i.:			
Line 2(a) taxes		37.50	
Multiplied by: line 6(c) dividend		0	
Dividend by: line 3(a) e & p			150.00
Result			0
(b) Taxes of T deemed paid by S for 1987 under section 902(b)(1) with regard to T's g.l.i.:			
Line 2(b) taxes		12.50	
Multiplied by: line 6(d) dividend		25.00	
Dividend by: line 3(b) e & p		50.00	
Result			6.25
S corporation (first-tier corporation):			
8. Pre-tax earnings and profits:			
(a) Dividends from T attributable to T's non-previously taxed p.i.	0		
Plus:			
(b) Dividends from T attributable to T's non-previously taxed g.l.i.	25		
Plus:			
(c) Dividends from T attributable to T's previously taxed p.i.	150		
Plus:			
(d) Dividends from T attributable to T's previously taxed g.l.i.	25		
Plus:			
(e) Passive income other than dividend from T	0		
Plus:			
(f) General limitation income other than dividend from T	100.00		
(g) Total pre-tax earnings and profits		300.00	
(h) Foreign income taxes paid on or with respect to S's earnings and profits (10%)		30.00	
(i) Earnings and profits			270.00
9. Allocation of taxes:			
(a) Foreign income taxes paid by S that are allocable to non-previously taxed p.i. earned by S:			
Line 8(h) taxes		30.00	
Multiplied by: foreign law line 8(a) & 8(e) p.i. amounts		0	
Dividend by: foreign law total net income		300.00	
Result			0
(b) Foreign income taxes paid by S that are allocable to S's previously taxed p.i. received from T:			
Line 8(h) taxes		30.00	
Multiplied by: foreign law line 8(c) p.i. amount		150.00	
Divided by: foreign law total net income		300.00	
Result			15.00
(c) Foreign income taxes paid by S that are allocable to non-previously taxed g.l.i. earned by S:			
Line 8(h) taxes		30.00	

Multiplied by: foreign law line 8(b) & line 8(f) g.l.i. amounts		125.00	
Divided by: foreign law total net income		300.00	
Result			12.50
(d) Foreign income taxes paid by S that are allocable to S's previously taxed g.l.i. received from T:			
Line 8(h) taxes		30.00	
Multiplied by: foreign law line 8(d) amount		25.00	
Divided by: foreign law total net income		300.00	
Result			2.50
10. (a) Non-previously taxed earnings and profits of S:			
Lines 8(a), 8(b), 8(e), & 8(f) e & p		125.00	
Less: lines 9(a) & 9(c) taxes		12.50	
Result			112.50
(b) Portion of result in 10(a) attributable to S's p.i.			0
(c) Portion of result in 10(a) attributable to S's g.l.i.			112.50
11. (a) Previously taxed earnings and profits of S:			
Lines 8(c) and 8(d) e & p		175.00	
Less: lines 9(b) & 9(d) taxes		17.50	
Result			157.50
(b) Portion of result in 11(a) attributable to T's p.i.:			
Line 8(c)		150.00	
Less: line 9(b) taxes		15.00	
Result			135.00
(c) Portion of result in 11(a) attributable to T's g.l.i.:			
Line 8(d)		25.00	
Less: line 9(d) taxes		2.50	
Result			22.50
12. Subpart F inclusion attributable to S:			
(a) Amount required to be included in P's gross income for 1988 under section 951 with respect to S that is attributable to S's p.i.			0
(b) Amount required to be included in P's gross income for 1988 under section 951 with respect to S that is attributable to S's g.l.i.			22.50
13. Foreign income taxes deemed paid by P under section 960(a)(1) with respect to S:			
(a) Taxes deemed paid that are attributable to S's subpart F inclusion that are attributable to S's p.i.:			
Line 9(a) taxes		0	
Multiplied by: line 12(a) sec. 951 incl.		0	
Divided by: line 10(b) e & p		0	
Result			0
(b) Taxes deemed paid that are attributable to S's subpart F inclusion that are attributable to S's g.l.i.:			
Line 9(c) taxes		12.50	
Multiplied by: line 12(b) sec. 951 incl.		22.50	
Divided by: line 10(c) e & p		112.50	
Result			2.50
(c) Foreign income taxes deemed paid by S deemed paid by P that are allocable to S's p.i.:			
Line 7(a) taxes deemed paid by S		0	
Multiplied by: line 12(a) sec. 951 incl.		0	
Divided by: line 10(b) e & p		0	
Result			0
(d) Foreign income taxes deemed paid by S deemed paid by P that are allocable to S's g.l.i.:			
Line 7(b) taxes deemed paid by S		6.25	
Multiplied by: line 12(b) sec. 951 incl.		22.50	
Divided by: line 10(c) e & p		112.50	
Result			1.25
14. Dividends paid to P:			
(a) Dividends from S attributable to S's previously taxed p.i.		0	
Plus:			
(b) Dividends from S attributable to S's previously taxed g.l.i.		22.50	
Plus:			
(c) Dividends to which section 902(a) applies:			
(i) Consisting of S's earnings and profits attributable to T's previously taxed p.i.	135.00		
Plus:			
(ii) Consisting of S's earnings and profits attributable to T's previously taxed g.l.i.	22.50		
Plus:			
(iii) Consisting of S's other p.i. earnings and profits	0		
Plus:			
(iv) Consisting of S's other g.l.i. earnings and profits	67.50		
(v) Total section 902 dividend		225.00	
(d) Total dividends paid to P			247.50

15. Foreign income taxes deemed paid by P under section 902 and section 960(a)(3) with respect to S:			
(a) Taxes paid by S deemed paid by P under section 902(a) with regard to S's p.i.:			
Line 9(a) taxes		0	
Multiplied by: line 14(c)(iii) div.		0	
Divided by: line 10(b) e & p		0	
Result			0
(b) Taxes paid by S deemed paid by P under section 902(a) with regard to S's g.l.i.:			
Line 9(c) taxes		12.50	
Multiplied by: line 14(c)(iv) div.		67.50	
Divided by: line 10(c) e & p		112.50	
Result			7.50
(c) Taxes deemed paid by S deemed paid by P under section 902(a) with regard to S's p.i.:			
Line 7(a) deemed paid taxes		0	
Multiplied by: line 14(c)(iii) div.		0	
Divided by: line 10(b) e & p		0	
Result			0
(d) Taxes deemed paid by S deemed paid by P under section 902(a) with regard to S's g.l.i.:			
Line 7(b) deemed paid taxes		6.25	
Multiplied by: line 14(c)(iv) div.		67.50	
Divided by: line 10(c) e & p		112.50	
Result			3.75
(e) Foreign income taxes paid by S under section 960(a)(3) deemed paid by P with regard to S's previously taxed p.i.:			
Line 9(b) taxes		15.00	
Multiplied by: line 14(c)(i) div.		135.00	
Divided by: line 11(b) e & p		135.00	
Result			15.00
(f) Foreign income taxes paid by S under section 960(a)(3) deemed paid by P with regard to S's previously taxed g.l.i.:			
Line 9(d) taxes		2.50	
Multiplied by: line 14(c)(ii) div.		22.50	
Divided by: line 11(c) e & p		22.50	
Result			2.50

Summary:			
Total taxes deemed paid by P under section 960(a)(1) with respect to—			
Passive income of S and T included under section 951 in income of P:			
Line 5(a)		37.50	
Plus:			
Line 13(a)		0	
Plus:			
Line 13(c)		0	
Result		37.50	
General limitation income of S and T included under section 951 in income of P:			
Line 5(b)		6.25	
Plus:			
Line 13(b)		2.50	
Plus:			
Line 13(d)		1.25	
Result		10.00	
Total deemed paid taxes under section 960(a)(1)		47.50	
Total taxes deemed paid by P under section 902 and section 960(a)(3) attributable to passive income of S and T (line 15(e))			15.00
Total taxes deemed paid by P under section 902 and section 960(a)(3) attributable to general limitation income of S and T:			
Line 15(b)		7.50	
Plus:			
Line 15(d)		3.75	
Plus:			
Line 15(f)		2.50	
Result		13.75	

[T.D. 8214, 53 FR 27029, July 18, 1988, as amended by T.D. 8412, 57 FR 20652, May 14, 1992; T.D. 9141, 69 FR 43308, July 20, 2004; T.D. 9260, 71 FR 24533, Apr. 25, 2006]

§ 1.904–7 Transition rules.

(a) *Characterization of distributions and section 951(a)(1) (A) (ii) and (iii) and (B) inclusions of earnings of a controlled foreign corporation accumulated in taxable years beginning before January 1, 1987, during taxable years of both the payor controlled foreign corporation and the recipient which begin after December 31, 1986*—(1) *Distributions and section 951(a)(1) (A) (ii) and (iii) and (B) inclusions.* Earnings accumulated in taxable years beginning before January 1, 1987, by a foreign corporation that was a controlled foreign corporation when

such earnings were accumulated are characterized in that foreign corporation's hands under section 904(d)(1)(A) (separate limitation interest income) or section 904(d)(1)(E) (general limitation income) (prior to their amendment by the Tax Reform Act of 1986 (the Act)) after application of the de minimis rule of former section 904(d)(3)(C) (prior to its amendment by the Act). When, in a taxable year after the effective date of the Act, earnings and profits attributable to such income are distributed to, or included in the gross income of, a United States shareholder under section 951(a)(1) (A) (ii) or (iii) or (B) (hereinafter in this section ''inclusions''), the ordering rules of section 904(d)(3)(D) and §1.904–5(c)(4) shall be applied in determining initially the character of the income of the distributee or United States shareholder. Thus, a proportionate amount of a distribution described in this paragraph initially will be characterized as separate limitation interest income in the hands of the distributee based on the ratio of the separate limitation interest earnings and profits out of which the dividend was paid to the total earnings and profits out of which the dividend was paid. The distribution or inclusions must then be recharacterized in the hands of the distributee or United States shareholder on the basis of the following principles:

(i) Distributions and inclusions that initially are characterized as separate limitation interest income shall be treated as passive income;

(ii) Distributions and inclusions that initially are characterized as old general limitation income shall be treated as general limitation income, unless the taxpayer establishes to the satisfaction of the Commissioner that the distribution or inclusion is attributable to:

(A) Earnings and profits accumulated with respect to shipping income, as defined in section 904(d)(2)(D) and §1.904–4(f); or

(B) In the case of a financial services entity, earnings and profits accumulated with respect to financial services income, as defined in section 904(d)(2)(C)(ii) and §1.904–4(e)(1); or

(C) Earnings and profits accumulated with respect to high withholding tax interest, as defined in section 904(d)(2)(B) and §1.904–4(d).

(2) *Limitation on establishing the character of earnings and profits.* In order for a taxpayer to establish that distributions or inclusions that are attributable to general limitation earnings and profits of a particular taxable year beginning before January 1, 1987, are attributable to shipping, financial services or high withholding tax interest earnings and profits, the taxpayer must establish the amounts of foreign taxes paid or accrued with respect to income attributable to those earnings and profits that are to be treated as taxes paid or accrued with respect to shipping, financial services or high withholding tax interest income, as the case may be, under section 904(d)(2)(I). Conversely, in order for a taxpayer to establish the amounts of general limitation taxes paid or accrued in a taxable year beginning before January 1, 1987, that are to be treated as taxes paid or accrued with respect to shipping, financial services or high withholding tax interest income, as the case may be, the taxpayer must establish the amount of any distributions or inclusions that are attributable to shipping, financial services or high withholding tax interest earnings and profits. For purposes of establishing the amounts of general limitation taxes that are to be treated as taxes paid or accrued with respect to shipping, financial services or high withholding tax interest income, the principles of §1.904–6 shall be applied.

(b) *Application of look-through rules to distributions (including deemed distributions) and payments by an entity to a recipient when one's taxable year begins before January 1, 1987 and the other's taxable year begins after December 31, 1986*—(1) *In general.* This paragraph provides rules relating to the application of section 904(d)(3) to payments made by a controlled foreign corporation or other entity to which the look-through rules apply during its taxable year beginning after December 31, 1986, but received in a taxable year of the recipient beginning before January 1, 1987. The paragraph also provides rules relating to distributions (including deemed distributions) or payments made by a controlled foreign corporation to which

section 904(d)(3) (as in effect before the Act) applies during its taxable year beginning before January 1, 1987, and received in a taxable year of the recipient beginning after December 31, 1986.

(2) *Payor of interest, rents, or royalties is subject to the Act and recipient is not subject to the Act.* If interest, rents, or royalties are paid or accrued on or after the start of the payor's first taxable year beginning on or after January 1, 1987, but prior to the start of the recipient's first taxable year beginning on or after January 1, 1987, such interest, rents, or royalties shall initially be characterized in accordance with section 904(d)(3) and §1.904–5. To the extent that interest payments in the hands of the recipient are initially characterized as passive income under these rules, they will be treated as separate limitation interest in the hands of the recipient. To the extent that rents or royalties in the hands of the recipient are initially characterized as passive income under these rules, they will be recharacterized as general limitation income in the hands of the recipient.

(3) *Recipient of interest, rents, or royalties is subject to the Act and payor is not subject to the Act.* If interest, rents, or royalties are paid or accrued before the start of the payor's first taxable year beginning on or after January 1, 1987, but on or after the start of the recipient's first taxable year beginning after January 1, 1987, the income in the recipient's hands shall be initially characterized in accordance with former section 904(d)(3) (prior to its amendment by the Act). To the extent interest income is characterized as separate limitation interest income under these rules, that income shall be recharacterized as passive income in the hands of the recipient. Rents or royalties will be characterized as general limitation income.

(4) *Recipient of dividends and subpart F inclusions is subject to the Act and payor is not subject to the Act.* If dividends are paid or accrued or section 951(a)(1) inclusions occur before the start of the first taxable year of a controlled foreign corporation beginning on or after January 1, 1987, but on or after the start of the first taxable year of the distributee or United States shareholder beginning on or after January 1, 1987, the dividends or section 951(a)(1) inclusions in the hands of the distributee or United States shareholder shall be initially characterized in accordance with former section 904(d)(3) (including the ordering rules of section 904(d)(3)(A). Therefore, under former section 904(d)(3)(A), dividends are considered to be paid or derived first from earnings attributable to separate limitation interest income. To the extent the dividend or section 951(a)(1) inclusion is initially characterized under these rules as separate limitation interest income in the hands of the distributee or United States shareholder, the dividend or section 951(a)(1) inclusion shall be recharacterized as passive income in the hands of the distributee or United States shareholder. The portion, if any, of the dividend or section 951(a)(1) inclusion that is not characterized as passive income shall be characterized according to the rules in paragraph (a) of this section. Therefore, a taxpayer may establish that income that would otherwise be characterized as general limitation income is shipping or financial services income. Rules comparable to the rules contained in section 904(d)(2)(I) shall be applied for purposes of characterizing foreign taxes deemed paid with respect to distributions and section 951(a)(1) inclusions covered by this paragraph (b)(4).

(5) *Examples.* The following examples illustrate the application of this paragraph (b).

Example 1. P is a domestic corporation that is a fiscal year taxpayer (July 1–June 30). S, a controlled foreign corporation, is a wholly-owned subsidiary of P and has a calendar taxable year. On June 1, 1987, S makes a $100 interest payment to P. Because the payment is made after January 1, 1987 (the first day of S's first taxable year beginning after December 31, 1986), the look-through rules of section 904(d)(3) apply to characterize the payment made by S. To the extent, however, that the interest payment to P is allocable to passive income earned by S, the payment will be included in P's separate limitation for interest as provided in former section 904(d)(1)(A).

Example 2. P is a domestic corporation that is a calendar year taxpayer. S, a controlled foreign corporation, is a wholly-owned subsidiary of P and has a July 1–June 30 taxable year. On June 1, 1987, S makes a $100 interest

payment to P. Because the payment is made prior to July 1, 1987 (the first day of S's first taxable year beginning after December 31, 1986), the look-through rules of section 904(d)(3) do not apply. Assume that, under former section 904(d)(3), the interest payment would be characterized as separate limitation interest income. For purposes of determining P's foreign tax credit limitation, the interest payment will be passive income as provided in section 904(d)(1)(A).

Example 3. The facts are the same as in *Example* 2 except that on June 1, 1987, S makes a $100 dividend distribution to P. Because the dividend is paid prior to July 1, 1987 (the first day of S's first taxable year beginning after December 31, 1986), the look-through rules of section 904(d)(3) do not apply. Assume that, under former section 904(d)(3), S's earnings and profits for the taxable year ending June 30, 1987, consist of $200 of earnings attributable to general limitation income and $75 of earnings attributable to separate limitation interest income. The portion of the dividend that is attributable to S's separate limitation interest and is treated as separate limitation interest income under former section 904(d)(3) is $75. The remaining $25 of the dividend is treated as general limitation income under former section 904(d)(3). For purposes of determining P's foreign tax credit limitation, $75 of the dividend will be recharacterized as passive income. The remaining $25 of the dividend will be characterized as general limitation income, unless P can establish that the general limitation portion is attributable to shipping or financial services income.

(c) *Installment sales*. If income is received or accrued by any person on or after the effective date of the Act (as applied to such person) that is attributable to a disposition of property by such person with regard to which section 453 or section 453A applies (installment sale treatment), and the disposition occurred prior to the effective date of the Act, that income shall be characterized according to the rules of §§ 1.904–4 through 1.904–7.

(d) *Special effective date for high withholding tax interest earned by persons with respect to qualified loans described in section 1201(e)(2) of the Act*. For purposes of characterizing interest received or accrued by any person, the definition of high withholding tax interest in § 1.904–4(d) shall apply to taxable years beginning after December 31, 1986, except as provided in section 1201(e)(2) of the Act.

(e) *Treatment of certain recapture income*. Except as otherwise provided, if income is subject to recapture under section 585(c), the income shall be general limitation income. If the income is recaptured by a taxpayer that is a financial services entity, the entity may treat the income as financial services income if the taxpayer establishes to the satisfaction of the Secretary that the deduction to which the recapture amount is attributable is allocable to financial services income. If the taxpayer establishes to the satisfaction of the Secretary that the deduction to which the recapture amount is attributable is allocable to high-withholding tax interest income, the taxpayer may treat the income as high-withholding tax interest.

(f) *Treatment of non-look-through pools of a noncontrolled section 902 corporation or a controlled foreign corporation in post-2002 taxable years*—(1) *Definition of non-look-through pools*. The term *non-look-through pools* means the pools of post-1986 undistributed earnings (as defined in § 1.902–1(a)(9)) that were accumulated, and post-1986 foreign income taxes (as defined in § 1.902–1(a)(8)) paid, accrued, or deemed paid, in and after the first taxable year in which the foreign corporation had a domestic shareholder (as defined in § 1.902–1(a)(1)) but before any such shareholder was eligible for look-through treatment with respect to dividends from the foreign corporation.

(2) *Treatment of non-look-through pools of a noncontrolled section 902 corporation*. Any undistributed earnings in the non-look-through pool that were accumulated in taxable years beginning before January 1, 2003, by a noncontrolled section 902 corporation as of the last day of the corporation's last taxable year beginning before January 1, 2003, shall be treated in taxable years beginning after December 31, 2002, as if they were accumulated during a period when a dividend paid by the noncontrolled section 902 corporation to a domestic shareholder would have been eligible for look-through treatment under section 904(d)(4) and § 1.904–5. Post-1986 foreign income taxes paid, accrued or deemed paid with respect to such earnings shall be treated as if they were paid, accrued or deemed paid during a period when the related earnings were eligible for look-through treatment.

Any such earnings and taxes in the non-look-through pools shall constitute the opening balance of the noncontrolled section 902 corporation's pools of post-1986 undistributed earnings and post-1986 foreign income taxes on the first day of the foreign corporation's first taxable year beginning after December 31, 2002, in accordance with the rules of paragraph (f)(4) of this section.

(3) *Treatment of non-look-through pools of a controlled foreign corporation.* A controlled foreign corporation may have non-look-through pools of post-1986 undistributed earnings and post-1986 foreign income taxes that were accumulated and paid in a taxable year beginning before January 1, 2003, in which it was a noncontrolled section 902 corporation. Any such undistributed earnings in the non-look-through pool as of the last day of the controlled foreign corporation's last taxable year beginning before January 1, 2003, shall be treated in taxable years beginning on or after January 1, 2003, as if they were accumulated during a period when a dividend paid by the controlled foreign corporation out of such earnings, or an amount included in the gross income of a United States shareholder under section 951 that is attributable to such earnings, would have been eligible for look-through treatment. Any post-1986 foreign income taxes paid, accrued, or deemed paid with respect to such earnings shall be treated in taxable years beginning on or after January 1, 2003, as if they were paid, accrued, or deemed paid during a period when a dividend or inclusion out of such earnings would have been eligible for look-through treatment. Any such undistributed earnings and taxes in the non-look-through pools shall be added to the pools of post-1986 undistributed earnings and post-1986 foreign income taxes of the controlled foreign corporation in the appropriate separate categories on the first day of the controlled foreign corporation's first taxable year beginning after December 31, 2002, in accordance with the rules of paragraph (f)(4) of this section. Similar rules shall apply to characterize any previously-taxed earnings and profits described in section 959(c)(1)(A) that are attributable to earnings in the non-look-through pool.

(4) *Substantiation of look-through character of undistributed earnings and taxes in a non-look-through pool*—(i) *Reconstruction of earnings and taxes pools.* In order to substantiate the look-through characterization of undistributed earnings and taxes in a non-look-through pool under section 904(d)(4) and §1.904–5, the taxpayer shall make a reasonable, good-faith effort to reconstruct the non-look-through pools of post-1986 undistributed earnings and post-1986 foreign income taxes (and previously-taxed earnings and profits, if any) on a look-through basis for each year in the non-look-through period, beginning with the first taxable year in which post-1986 undistributed earnings were accumulated in the non-look-through pool. Reconstruction shall be based on reasonably available books and records and other relevant information, and it must account for earnings distributed and taxes deemed paid in these years as if they were distributed and deemed paid pro rata from the amounts that were added to the non-look-through pools during the non-look-through period.

(ii) *Safe harbor method.* A taxpayer that was eligible for look-through treatment with respect to a distribution from the foreign corporation in the taxpayer's first taxable year ending after the first day of the foreign corporation's first taxable year beginning after December 31, 2002, may allocate the undistributed earnings and taxes in the non-look-through pools to the foreign corporation's look-through pools of post-1986 undistributed earnings and post-1986 foreign income taxes in other separate categories on the first day of the foreign corporation's first taxable year beginning after December 31, 2002, in the same percentages as the taxpayer properly characterizes the stock of the foreign corporation in the separate categories for purposes of apportioning the taxpayer's interest expense in its first taxable year ending after the first day of the foreign corporation's first taxable year beginning after December 31, 2002, under §1.861–12T(c)(3) or §1.861–12(c)(4), as the case may be. If the modified gross income method described in §1.861–9T(j) is used

to apportion interest expense of the foreign corporation in its first taxable year beginning after December 31, 2002, the taxpayer must allocate the undistributed earnings and taxes in the non-look-through pools to the foreign corporation's look-through pools of post-1986 undistributed earnings and post-1986 foreign income taxes based on an average of the foreign corporation's modified gross income ratios for the foreign corporation's taxable years beginning in 2003 and 2004. A taxpayer may also use the safe harbor method described in this paragraph (f)(4)(ii) to allocate to separate categories any previously-taxed earnings and profits described in section 959(c)(1)(A) that are attributable to the non-look-through pool. A taxpayer may choose to use the safe harbor method on either a timely filed or amended tax return or during an audit. However, a taxpayer that uses the safe harbor method on an amended return or in the course of an audit must make appropriate adjustments to eliminate any duplicate benefits arising from application of the safe harbor method to taxable years that are not open for assessment. A taxpayer's choice to use the safe harbor method is evidenced by employing the method. The taxpayer need not file any separate statement.

(iii) *Inadequate substantiation.* If a taxpayer does not use, or is ineligible to use, the safe harbor method described in paragraph (f)(4)(ii) of this section and the Commissioner determines that the look-through characterization of earnings and taxes in the non-look-through pools cannot reasonably be determined based on the available information, the Commissioner shall allocate the undistributed earnings and taxes in the non-look-through pools to the foreign corporation's passive category.

(iv) *Examples.* The following examples illustrate the application of this paragraph (f)(4):

Example 1. P, a domestic corporation, has owned 50 percent of the voting stock of S, a foreign corporation, at all times since January 1, 1987, and S has been a noncontrolled section 902 corporation with respect to P since that date. P and S use the calendar year as their U.S. taxable year. The first year in which post-1986 undistributed earnings were accumulated in the non-look-through pool of S was 1987. As of December 31, 2002, S had 200u of post-1986 undistributed earnings and $100 of post-1986 foreign income taxes in its non-look-through pools. P does not use the safe harbor method under paragraph (f)(4)(ii) of this section to allocate the earnings and taxes in the non-look-through pools to S's other separate categories and does not attempt to substantiate the look-through characterization of S's non-look-through pools. The Commissioner, however, reasonably determines, based on information used to characterize S's stock for purposes of apportioning P's interest expense in P's 2003 and 2004 taxable years, that 100u of the earnings and all $100 of the taxes in the non-look-through pools are properly assigned on a look-through basis to the general limitation category, and 100u of earnings and no taxes are properly assigned on a look-through basis to the passive category. Therefore, in accordance with the Commissioner's look-through characterization of the earnings and taxes in S's non-look-through pools, on January 1, 2003, S has 100u of post-1986 undistributed earnings and $100 of post-1986 foreign income taxes in the general limitation category and 100u of post-1986 undistributed earnings and no post-1986 foreign income taxes in the passive category.

Example 2. The facts are the same as in *Example 1,* except that the Commissioner cannot reasonably determine, based on the available information, the proper look-through characterization of the 200u of undistributed earnings and $100 of taxes in S's non-look-through pools. Accordingly, the Commissioner will assign such earnings and taxes to the passive category, so that as of January 1, 2003, S has 200u of post-1986 undistributed earnings and $100 of post-1986 foreign income taxes in the passive category, and the Commissioner will treat S as a passive category asset for purposes of apportioning P's interest expense.

(5) *Treatment of a deficit accumulated in a non-look-through pool.* Any deficit in the non-look-through pool of a noncontrolled section 902 corporation or a controlled foreign corporation as of the end of its last taxable year beginning before January 1, 2003, shall be treated in taxable years beginning after December 31, 2002, as if the deficit had been accumulated during a period in which a dividend paid by the foreign corporation would have been eligible for look-through treatment. In the case of a noncontrolled section 902 corporation, the deficit and taxes, if any, in the non-look-through pools shall constitute the opening balance of the look-

through pools of post-1986 undistributed earnings and post-1986 foreign income taxes of the noncontrolled section 902 corporation in the appropriate separate categories on the first day of its first taxable year beginning after December 31, 2002. In the case of a controlled foreign corporation, the deficit and taxes, if any, in the non-look-through pools shall be added to the balance of the look-through pools of post-1986 undistributed earnings and post-1986 foreign income taxes of the controlled foreign corporation in the appropriate separate categories on the first day of its first taxable year beginning after December 31, 2002. The taxpayer must substantiate the look-through characterization of the deficit and taxes in accordance with the rules of paragraph (f)(4) of this section. If a taxpayer does not use the safe harbor method described in paragraph (f)(4)(ii) of this section and the Commissioner determines that the look-through characterization of the deficit and taxes cannot reasonably be determined based on the available information, the Commissioner shall allocate the deficit and taxes, if any, in the non-look-through pools to the foreign corporation's passive category. If, as of the end of a taxable year beginning after December 31, 2002, in which it pays a dividend, the foreign corporation has zero or a deficit in post-1986 undistributed earnings (taking into account any earnings or a deficit accumulated in taxable years beginning before January 1, 2003), the deficit in post-1986 undistributed earnings shall be carried back to reduce pre-1987 accumulated profits, if any, on a last-in first-out basis. *See* §1.902–2(a)(1). If, as of the end of a taxable year beginning after December 31, 2002, in which the foreign corporation pays a dividend out of current earnings and profits, it has zero or a deficit in post-1986 undistributed earnings (taking into account any earnings or a deficit accumulated in taxable years beginning before January 1, 2003), and the sum of current plus accumulated earnings and profits is zero or less than zero, no foreign taxes shall be deemed paid with respect to the dividend. *See* §1.902–1(b)(4).

(6) *Treatment of pre-1987 accumulated profits.* Any pre-1987 accumulated profits (as defined in §1.902–1(a)(10)) of a controlled foreign corporation or noncontrolled section 902 corporation shall be treated in taxable years beginning after December 31, 2002, as if they were accumulated during a period in which a dividend paid by the foreign corporation would have been eligible for look-through treatment. Any pre-1987 foreign income taxes (as defined in §1.902–1(a)(10)(iii)) shall be treated as if they were paid, accrued or deemed paid during a year when a dividend out of the related pre-1987 accumulated profits would have been eligible for look-through treatment. The taxpayer must substantiate the look-through characterization of the pre-1987 accumulated profits and pre-1987 foreign income taxes in accordance with the rules of paragraph (f)(4) of this section. If a taxpayer does not use, or is ineligible to use, the safe harbor method described in paragraph (f)(4)(ii) of this section and the Commissioner determines that the look-through characterization of the pre-1987 accumulated profits and pre-1987 foreign income taxes cannot reasonably be determined based on the available information, the pre-1987 accumulated profits and pre-1987 foreign income taxes shall be allocated to the foreign corporation's passive category.

(7) *Treatment of post-1986 undistributed earnings or a deficit of a controlled foreign corporation attributable to dividends from a noncontrolled section 902 corporation paid in taxable years beginning before January 1, 2003*—(i) *Look-through treatment of post-1986 undistributed earnings at controlled foreign corporation level.* Dividends paid by a noncontrolled section 902 corporation to a controlled foreign corporation in post-1986 taxable years of the noncontrolled section 902 corporation beginning before January 1, 2003, were assigned to a separate category for dividends from that noncontrolled section 902 corporation. Beginning on the first day of the controlled foreign corporation's first taxable year beginning on or after the first day of the lower-tier corporation's first taxable year beginning after December 31, 2002, any post-1986 undistributed earnings, or previously-taxed earnings and profits described in section 959(c)(1) or (2), of the controlled foreign corporation in such a separate category shall

be treated as if they were accumulated during a period when a dividend paid by the noncontrolled section 902 corporation would have been eligible for look-through treatment. Any post-1986 foreign income taxes in such a separate category shall also be treated as if they were paid, accrued or deemed paid during a period when such a dividend would have been eligible for look-through treatment. Any such post-1986 undistributed earnings and post-1986 foreign income taxes in a separate category for dividends from a noncontrolled section 902 corporation shall be added to the opening balance of the controlled foreign corporation's look-through pools of post-1986 undistributed earnings and post-1986 foreign income taxes in the appropriate separate categories on the first day of the controlled foreign corporation's first taxable year beginning on or after the first day of the lower-tier corporation's first taxable year beginning after December 31, 2002. Any section 952(c)(2) recapture account with respect to such a separate category shall be allocated in the same manner as the associated post-1986 undistributed earnings. The taxpayer must substantiate the look-through characterization of such earnings and taxes in accordance with the rules of paragraph (f)(7)(iii) of this section.

(ii) *Look-through treatment of deficit in post-1986 undistributed earnings at controlled foreign corporation level.* If a controlled foreign corporation has a deficit in a separate category for dividends from a lower-tier noncontrolled section 902 corporation that is a member of the controlled foreign corporation's qualified group as defined in section 902(b)(2), such deficit shall be treated in taxable years of the upper-tier corporation beginning on or after the first day of the lower-tier corporation's first taxable year beginning after December 31, 2002, as if the deficit had been accumulated during a period in which a dividend from the lower-tier corporation would have been eligible for look-through treatment. Any post-1986 foreign income taxes in the separate category for dividends from the noncontrolled section 902 corporation shall also be treated as if they were paid, accrued or deemed paid during a period when the dividends were eligible for look-through treatment. The deficit and related post-1986 foreign income taxes, if any, shall be added to the opening balance of the controlled foreign corporation's look-through pools of post-1986 undistributed earnings and post-1986 foreign income taxes in the appropriate separate categories on the first day of the controlled foreign corporation's first taxable year beginning on or after the first day of the lower-tier corporation's first taxable year beginning after December 31, 2002. The taxpayer must substantiate the look-through characterization of the deficit and taxes in accordance with the rules of paragraph (f)(7)(iii) of this section.

(iii) *Substantiation required for look-through treatment.* The taxpayer must substantiate the look-through characterization of post-1986 undistributed earnings, previously-taxed earnings and profits, or a deficit in post-1986 undistributed earnings in a separate category for dividends paid by a noncontrolled section 902 corporation in taxable years beginning before January 1, 2003, by making a reasonable, good-faith effort to reconstruct the earnings (or deficit) and taxes in the separate category at the level of the controlled foreign corporation on a look-through basis, in accordance with the principles of paragraph (f)(4)(i) of this section. Alternatively, the taxpayer may allocate the earnings (or deficit) and taxes to the controlled foreign corporation's look-through pools under the safe harbor method described in paragraph (f)(4)(ii) of this section at the level of the controlled foreign corporation. If the taxpayer uses the safe harbor method, the earnings (or deficit) and taxes shall be allocated to the controlled foreign corporation's look-through pools in the appropriate separate categories on the first day of the controlled foreign corporation's first taxable year beginning on or after the first day of the lower-tier corporation's first taxable year beginning after December 31, 2002. The allocation shall be made in the same percentages as the controlled foreign corporation would properly characterize the stock of the lower-tier noncontrolled section 902 corporation in the separate categories

for purposes of apportioning the controlled foreign corporation's interest expense in its first taxable year ending after the first day of the noncontrolled section 902 corporation's first taxable year beginning after December 31, 2002. Under §1.861–12T(c)(3), the apportionment ratios properly used by the controlled foreign corporation are in turn based on the apportionment ratios properly used by the noncontrolled section 902 corporation to apportion its interest expense in its first taxable year beginning after December 31, 2002. In the case of a taxpayer that uses the safe harbor method where the lower-tier noncontrolled section 902 corporation uses the modified gross income method described in §1.861–9T(j) to apportion interest expense for its first taxable year beginning after December 31, 2002, earnings (or a deficit) and taxes in the separate category for dividends from the noncontrolled section 902 corporation shall be allocated to the look-through pools based on the average of the noncontrolled section 902 corporation's modified gross income ratios for its taxable years beginning in 2003 and 2004. In the case of a controlled foreign corporation that has in its qualified group a chain of lower-tier noncontrolled section 902 corporations, the safe harbor applies first to characterize the stock of the third-tier corporation and then to characterize the stock of the second-tier corporation. Where a taxpayer uses the safe harbor method with respect to a lower-tier noncontrolled section 902 corporation with respect to which the taxpayer did not meet the requirements of section 902(a) as of the end of the upper-tier controlled foreign corporation's last taxable year beginning before January 1, 2003, the earnings (or deficit) and taxes in the separate category for dividends from the lower-tier corporation shall be allocated to the upper-tier corporation's look-through pools in the separate categories in the same percentages as the stock of the lower-tier corporation would have been characterized for purposes of apportioning the upper-tier corporation's interest expense in the last year the taxpayer met the ownership requirements of section 902(a) with respect to the lower-tier corporation if the look-through rules had applied in that year. If a taxpayer does not use the safe harbor method described in this paragraph (f)(7)(iii), and the Commissioner determines that the look-through characterization of the earnings (or deficit) and taxes cannot reasonably be determined based on the available information, the Commissioner shall allocate the earnings (or deficit) and associated foreign income taxes to the controlled foreign corporation's passive category.

(8) *Treatment of distributions received by an upper-tier corporation from a lower-tier noncontrolled section 902 corporation, including when the corporations do not have the same taxable years*—(i) *Rule.* In the case of dividends paid by a lower-tier noncontrolled section 902 corporation to an upper-tier corporation where both are members of the same qualified group as defined in section 902(b)(2), the following rules apply. Dividends paid by the lower-tier corporation in taxable years beginning before January 1, 2003, are assigned to a separate category for dividends from that corporation, regardless of whether the corresponding taxable year of the recipient corporation began after December 31, 2002. Post-1986 undistributed earnings, previously-taxed earnings and profits, and post-1986 foreign income taxes in such a separate category shall be treated, beginning on the first day of the upper-tier corporation's first taxable year beginning on or after the first day of the lower-tier corporation's first taxable year beginning after December 31, 2002, as if they were accumulated during a period when a dividend paid by the lower-tier corporation would have been eligible for look-through treatment under section 904(d)(4) and §1.904–5. Dividends paid by a lower-tier corporation in taxable years beginning after December 31, 2002, are eligible for look-through treatment when paid, without regard to whether the corresponding taxable year of the recipient upper-tier corporation began after December 31, 2002.

(ii) *Example.* The following example illustrates the application of paragraph (f) of this section:

Example. M, a domestic corporation, has directly owned 50 percent of the stock of foreign corporation X, and X has directly owned 50 percent of the stock of foreign corporation

Y, at all times since X and Y were organized on January 1, 1990. Accordingly, X and Y are noncontrolled section 902 corporations with respect to M, and X and Y are members of the same qualified group. M and Y use the calendar year as their U.S. taxable year, and X uses a taxable year beginning on July 1. Under §1.904–4(g) and paragraph (f)(10) of this section, a dividend paid to M by X on January 15, 2003 (during X's last pre-2003 taxable year) is not eligible for look-through treatment in 2003. However, under §1.861–12(c)(4), M will characterize the stock of X on a look-through basis for purposes of interest expense apportionment in its 2003 taxable year. Under §1.904–2(h)(1), any unused foreign taxes in M's separate category for dividends from X will be carried over to M's other separate categories on a look-through basis for M's taxable years beginning on and after January 1, 2004. Under paragraph (f)(2) of this section, any undistributed earnings and taxes in X's non-look-through pools will be allocated to X's other separate categories on July 1, 2003. Under §1.904–5(i)(4) and paragraphs (f)(8)(i) and (f)(10) of this section, a dividend paid to X by Y on January 15, 2003 (during Y's first post-2002 taxable year) is eligible for look-through treatment when paid, notwithstanding that it is received in a pre-2003 taxable year of X.

(9) *Election to apply pre-AJCA rules to 2003 and 2004 taxable years*—(i) *Definition*. The term *single category for dividends from all noncontrolled section 902 corporations* means the separate category described in section 904(d)(1)(E) as in effect for taxable years beginning after December 31, 2002, and prior to its repeal by the American Jobs Creation Act (AJCA), Public Law 108–357, 118 Stat. 1418 (October 22, 2004).

(ii) *Time, manner, and form of election*. A taxpayer may elect not to apply the provisions of section 403 of the AJCA and to apply the rules of this paragraph (f)(9) to taxable years of noncontrolled section 902 corporations beginning after December 31, 2002, and before January 1, 2005, without regard to whether the corresponding taxable years of the taxpayer or any upper-tier corporation begin before or after such dates. A taxpayer shall be eligible to make such an election provided that—

(A) The taxpayer's tax liability as shown on an original or amended tax return for each of its affected taxable years is consistent with the rules of this paragraph (f)(9), the guidance set forth in Notice 2003–5 (2003–1 CB 294) (*see* §601.601(d)(2) of this chapter), and the principles of §1.861–12(c)(4) for each such year for which the statute of limitations does not preclude the filing of an amended return;

(B) The taxpayer makes appropriate adjustments to eliminate any duplicate benefits arising from the application of this paragraph (f)(9) to taxable years that are not open for assessment; and

(C) The taxpayer attaches a statement to its next tax return for which the due date (with extensions) is more than 90 days after April 25, 2006, indicating that the taxpayer elects not to apply the provisions of section 403 of the AJCA to taxable years of its noncontrolled section 902 corporations beginning in 2003 and 2004, and that the taxpayer has filed original returns or will file amended returns reflecting tax liabilities for each affected year that satisfy the requirements described in this paragraph (f)(9)(ii).

(iii) *Treatment of non-look-through pools in taxable years beginning after December 31, 2004*. Undistributed earnings (or a deficit) and taxes in the non-look-through pools of a controlled foreign corporation or a noncontrolled section 902 corporation as of the end of its last taxable year beginning before January 1, 2005, shall be treated in taxable years beginning after December 31, 2004, as if they were accumulated and paid during a period in which a distribution out of earnings in the non-look-through pool would have been eligible for look-through treatment. Such earnings (or deficit) and taxes shall be added to the foreign corporation's pools of post-1986 undistributed earnings and post-1986 foreign income taxes in the appropriate separate categories on the first day of the foreign corporation's first taxable year beginning after December 31, 2004. In accordance with the principles of paragraph (f)(4) of this section, the taxpayer must reconstruct the non-look-through pools or, if the taxpayer chooses to use the safe harbor method, allocate the earnings and taxes in the non-look-through pools to the foreign corporation's look-through pools in the appropriate separate categories on the first day of the foreign corporation's first taxable year beginning after December 31, 2004. Under the safe harbor method, this allocation is made in the

same percentages as the taxpayer properly characterized the stock of the foreign corporation for purposes of apportioning the taxpayer's interest expense in the taxpayer's first taxable year ending after the first day of the foreign corporation's first taxable year beginning after December 31, 2002. *See* §1.861–12T(c)(3) and §1.861–12(c)(4). If a taxpayer does not use the safe harbor method described in paragraph (f)(4)(ii) of this section and the Commissioner determines that the look-through characterization of the earnings (or deficit) and taxes cannot reasonably be determined based on the available information, the earnings (or deficit) and taxes shall be allocated to the foreign corporation's passive category.

(iv) *Carryover of unused foreign tax*. To the extent that a taxpayer has unused foreign taxes in the single category for dividends from all noncontrolled section 902 corporations, such taxes shall be carried forward to the appropriate separate categories in the taxpayer's taxable years beginning on or after the first day of the relevant noncontrolled section 902 corporation's first taxable year beginning after December 31, 2004. Such unused taxes shall be carried forward in the same manner as §1.904–2(h)(1) provides that unused foreign taxes in the separate categories for dividends from each noncontrolled section 902 corporation are carried over to taxable years beginning on or after the first day of the noncontrolled section 902 corporation's first taxable year beginning after December 31, 2002, in the case of a taxpayer that does not make the election under this paragraph (f)(9). The electing taxpayer shall determine which noncontrolled section 902 corporations paid the dividends to which the unused foreign taxes are attributable and assign the taxes to the appropriate separate categories as if such dividends had been eligible for look-through treatment when paid. Accordingly, the taxpayer must substantiate the look-through characterization of the unused foreign taxes in accordance with paragraph (f)(4) of this section by reconstructing the non-look-through pools or, if the taxpayer uses the safe harbor method, by allocating the unused foreign taxes to other separate categories in the same percentages as the taxpayer properly characterized the stock of the noncontrolled section 902 corporation for purposes of apportioning the taxpayer's interest expense for its first taxable year ending after the first day of the noncontrolled section 902 corporation's first taxable year beginning after December 31, 2002. The rule described in this paragraph (f)(9)(iv) shall apply only to unused foreign taxes attributable to dividends out of earnings that were accumulated by noncontrolled section 902 corporations in taxable years of such corporations beginning before January 1, 2003, because only unused foreign taxes attributable to distributions out of pre-2003 earnings are included in the single category for dividends from all noncontrolled section 902 corporations. To the extent that unused foreign taxes carried forward to the single category for dividends from all noncontrolled section 902 corporations under the rules of Notice 2003–5 were either absorbed by low-taxed dividends paid by noncontrolled section 902 corporations out of the non-look-through pool in taxable years of such corporations beginning in 2003 or 2004, or expired unused, the amount of taxes carried forward to the separate categories on a look-through basis will be smaller than the aggregate amount of taxes initially carried forward to the single category for dividends from all noncontrolled section 902 corporations. In this case, the unused foreign taxes arising in each taxable year shall be deemed attributable to each noncontrolled section 902 corporation in the same ratio as the dividends included in the separate category that were paid by such corporation in such year bears to all such dividends paid by all noncontrolled section 902 corporations in such year. Unused foreign taxes carried forward from the separate categories for dividends from each noncontrolled section 902 corporation to the single category for dividends from all noncontrolled section 902 corporations will similarly be deemed to have been utilized on a pro rata basis. The remaining unused foreign taxes are then assigned to the appropriate separate categories under the rules of paragraph (f)(4) of this section. Unused foreign taxes shall be treated

as allocable to general category income to the extent that such taxes would otherwise have been allocable to passive income (based on reconstructed pools or the safe harbor method), or to the extent that, under paragraph (f)(4)(iii) of this section, the Commissioner determines that the look-through characterization cannot reasonably be determined based on the available information.

(v) *Carryback of unused foreign tax.* To the extent that a taxpayer has unused foreign taxes attributable to a dividend paid by a noncontrolled section 902 corporation that was eligible for look-through treatment under section 904(d)(4) and § 1.904–5, any such unused foreign taxes shall be carried back to prior taxable years within the same separate category and not to the single category for dividends from all noncontrolled section 902 corporations or any separate category for dividends from a noncontrolled section 902 corporation. See Notice 2003–5 for rules relating to the carryback of unused foreign taxes in the single category for dividends from all noncontrolled section 902 corporations.

(vi) *Recapture of overall foreign loss or separate limitation loss in the single category for dividends from all noncontrolled section 902 corporations.* To the extent that a taxpayer has a balance in a separate limitation loss or overall foreign loss account in the single category for dividends from all noncontrolled section 902 corporations under section 904(d)(1)(E) (prior to its repeal by the AJCA), at the end of the taxpayer's last taxable year beginning before January 1, 2005 (or a later taxable year in which the taxpayer received a dividend subject to the separate limitation for dividends from all noncontrolled section 902 corporations), the amount of such balance shall be allocated on the first day of the taxpayer's next taxable year to the taxpayer's other separate categories. The amount of such balance that is attributable to each noncontrolled section 902 corporation shall be allocated in the same percentages as the taxpayer properly characterized the stock of such corporation for purposes of apportioning the taxpayer's interest expense for its first taxable year ending after the first day of such corporation's first taxable year beginning after December 31, 2002, under § 1.861–12T(c)(3) or § 1.861–12(c)(4), as the case may be. To the extent that a taxpayer has a balance in a separate limitation loss account for the single category for dividends from all noncontrolled section 902 corporations with respect to another separate category, and the separate limitation loss account would otherwise be assigned to that other category under this paragraph (f)(9)(vi), such balance shall be eliminated.

(vii) *Recapture of separate limitation losses in other separate categories.* To the extent that a taxpayer has a balance in any separate limitation loss account in a separate category with respect to the single category for dividends from all noncontrolled section 902 corporations at the end of the taxpayer's last taxable year with or within which ends the last taxable year of the relevant noncontrolled section 902 corporation beginning before January 1, 2005, such loss shall be recaptured in subsequent taxable years as income in the appropriate separate category. The separate limitation loss account shall be deemed attributable on a pro rata basis to those noncontrolled section 902 corporations that paid dividends out of earnings accumulated in taxable years beginning before January 1, 2003, in the years in which the separate limitation loss in the other separate category arose. The ratable portions of the separate limitation loss account shall be recaptured as income in the taxpayer's separate categories in the same percentages as the taxpayer properly characterized the stock of the relevant noncontrolled section 902 corporation for purposes of apportioning the taxpayer's interest expense in its first taxable year ending after the first day of such corporation's first taxable year beginning after December 31, 2002, under § 1.861–12T(c)(3) or § 1.861–12(c)(4), as the case may be. To the extent that a taxpayer has a balance in any separate limitation loss account in any separate category that would have been recaptured as income in that same category under this paragraph (f)(9)(vii), such balance shall be eliminated.

(viii) *Treatment of undistributed earnings in an upper-tier corporation-level single category for dividends from lower-*

tier noncontrolled section 902 corporations. Where a controlled foreign corporation or noncontrolled section 902 corporation has a single category for dividends from all noncontrolled section 902 corporations containing earnings attributable to dividends paid by one or more lower-tier corporations, the following rules apply. The post-1986 undistributed earnings, previously-taxed earnings and profits described in section 959(c)(1) or (2), if any, and associated post-1986 foreign income taxes shall be allocated to the upper-tier corporation's other separate categories in the same manner as earnings and taxes in a separate category for dividends from each noncontrolled section 902 corporation maintained by the upper-tier corporation are allocated under paragraph (f)(7) of this section. Accordingly, post-1986 undistributed earnings, previously-taxed earnings and profits, if any, and post-1986 foreign income taxes in the single category for dividends from all noncontrolled section 902 corporations shall be treated as if they were accumulated and paid, accrued or deemed paid during a period when a dividend paid by each lower-tier corporation that paid dividends included in the single category would have been eligible for look-through treatment. If the taxpayer uses the safe harbor method described in paragraph (f)(7)(iii) of this section, the earnings and taxes shall be allocated based on the apportionment ratios properly used by the lower-tier corporation to apportion its interest expense for its first taxable year beginning after December 31, 2002. Any section 952(c)(2) recapture account with respect to the single category shall be allocated in the same manner as the associated post-1986 undistributed earnings. The taxpayer must substantiate the look-through characterization of the earnings and taxes in accordance with the rules of paragraph (f)(7)(iii) of this section. If the taxpayer does not use the safe harbor method and the Commissioner determines that the look-through characterization of the earnings cannot reasonably be determined based on the available information, the earnings and taxes shall be assigned to the upper-tier corporation's passive category.

(ix) *Treatment of a deficit in the single category for dividends from lower-tier noncontrolled section 902 corporations*. Where a controlled foreign corporation or noncontrolled section 902 corporation had an aggregate deficit in the single category for dividends from all noncontrolled section 902 corporations as of the end of the upper-tier corporation's last taxable year beginning before January 1, 2005, such deficit and the associated post-1986 foreign income taxes, if any, shall be allocated to the upper-tier corporation's other separate categories in the same percentages in which the non-look-through pools of each lower-tier corporation to which the deficit is attributable were assigned to such corporation's other separate categories in its first taxable year beginning after December 31, 2002. If the taxpayer uses the safe harbor method described in paragraph (f)(7)(iii) of this section, the deficit and taxes shall be allocated based on how the taxpayer properly characterized the stock of the lower-tier noncontrolled section 902 corporation for purposes of apportioning the upper-tier corporation's interest expense for the upper-tier corporation's first taxable year ending after the first day of the lower-tier corporation's first taxable year beginning after December 31, 2002. The taxpayer must substantiate the look-through characterization of the deficit and taxes in accordance with the rules of paragraph (f)(7)(iii) of this section. If the taxpayer does not use the safe harbor method and the Commissioner determines that the look-through characterization of the deficit cannot reasonably be determined based on the available information, the deficit and taxes shall be assigned to the upper-tier corporation's passive category.

(10) *Effective/applicability date*. This paragraph (f) shall apply to dividends from a noncontrolled section 902 corporation that are paid in taxable years of the noncontrolled section 902 corporation ending on or after April 20, 2009. *See* 26 CFR §1.904–7T(f) (revised as of April 1, 2009) for rules applicable, except in the case of a taxpayer that makes the election under paragraph (f)(9) of that section, to dividends from a noncontrolled section 902 corporation

that are paid in taxable years of the noncontrolled section 902 corporation beginning after December 31, 2002, and ending before April 20, 2009. *See* 26 CFR 1.904–7T(f) (revised as of April 1, 2009) for rules applicable, in the case of a taxpayer that makes the election under paragraph (f)(9) of that section, to dividends from a noncontrolled section 902 corporation that are paid in taxable years of the noncontrolled section 902 corporation beginning after December 31, 2004, and ending before April 20, 2009. However, taxpayers may choose to apply paragraph (f) of this section in its entirety in lieu of 26 CFR 1.904–7T(f) to all dividends paid in periods covered by the temporary regulations, provided that appropriate adjustments are made to eliminate duplicate benefits arising from application of paragraph (f) to taxable years that are not open for assessment.

(g) *Treatment of earnings and foreign taxes of a controlled foreign corporation or a noncontrolled section 902 corporation accumulated in taxable years beginning before January 1, 2007*—(1) *Definitions*—(i) *Pre-2007 pools* means the pools in each separate category of post-1986 undistributed earnings (as defined in §1.902–1(a)(9)) that were accumulated, and post-1986 foreign income taxes (as defined in §1.902–1(a)(8)) paid, accrued, or deemed paid, in taxable years beginning before January 1, 2007.

(ii) *Pre-2007 separate categories* means the separate categories of income described in section 904(d) as applicable to taxable years beginning before January 1, 2007, and any other separate category of income described in §1.904–4(m).

(iii) *Post-2006 separate categories* means the separate categories of income described in section 904(d) as applicable to taxable years beginning after December 31, 2006, and any other separate category of income described in §1.904–4(m).

(2) *Treatment of pre-2007 pools of a controlled foreign corporation or a noncontrolled section 902 corporation*. Any post-1986 undistributed earnings in a pre-2007 pool of a controlled foreign corporation or a noncontrolled section 902 corporation shall be treated in taxable years beginning after December 31, 2006, as if they were accumulated during a period in which the rules governing the determination of post-2006 separate categories applied. Post-1986 foreign income taxes paid, accrued, or deemed paid with respect to such earnings shall be treated as if they were paid, accrued, or deemed paid during a period in which the rules governing the determination of post-2006 separate categories (including the rules of section 904(d)(3)(E)) applied as well. Any such earnings and taxes in pre-2007 pools shall constitute the opening balance of the foreign corporation's post-1986 undistributed earnings and post-1986 foreign income taxes on the first day of the foreign corporation's first taxable year beginning after December 31, 2006, in accordance with the rules of paragraph (g)(3) of this section. Similar rules shall apply to characterize any deficits in the pre-2007 pools and previously-taxed earnings and profits described in section 959(c)(1) and (2) that are attributable to earnings in the pre-2007 pools. Any section 952(c)(2) recapture account with respect to a separate category shall be allocated in the same manner as the post-1986 undistributed earnings in the associated pre-2007 pool.

(3) *Substantiation of post-2006 character of earnings and taxes in a pre-2007 pool*—(i) *Reconstruction of earnings and taxes pools*. In order to substantiate the post-2006 characterization of post-1986 undistributed earnings (as well as deficits and previously-taxed earnings, if any) and post-1986 foreign income taxes in pre-2007 pools of a controlled foreign corporation or a noncontrolled section 902 corporation, the taxpayer shall make a reasonable, good-faith effort to reconstruct the pre-2007 pools of post-1986 undistributed earnings (as well as deficits and previously-taxed earnings, if any) and post-1986 foreign income taxes following the rules governing the determination of post-2006 separate categories for each taxable year beginning before January 1, 2007, beginning with the first year in which post-1986 undistributed earnings were accumulated in the pre-2007 pool. Reconstruction shall be based on reasonably available books and records and other relevant information. To the extent any pre-2007 separate category includes earnings that would be allocated to

more than one post-2006 separate category, the taxpayer must account for earnings distributed and taxes deemed paid in these years for such category as if they were distributed and deemed paid pro rata from the amounts that were added to that category during each taxable year beginning before January 1, 2007.

(ii) *Safe harbor method*—(A) *In general.* Subject to the rules of paragraph (g)(3)(iii) of this section, a taxpayer may allocate the post-1986 undistributed earnings and post-1986 foreign income taxes in pre-2007 pools of a controlled foreign corporation or a noncontrolled section 902 corporation (as well as deficits and previously-taxed earnings, if any) under one of the safe harbor methods described in paragraphs (g)(3)(ii)(B) and (g)(3)(ii)(C) of this section. A taxpayer may choose to use the safe harbor method on a timely filed (original or amended) tax return or during an audit. A taxpayer that uses the safe harbor method on an amended return or in the course of an audit must make appropriate adjustments to eliminate any double benefit arising from application of the safe harbor method to years that are not open for assessment. A taxpayer's choice to use the safe harbor method is evidenced by employing the method. The taxpayer need not file any separate statement.

(B) *General safe harbor method*—(*1*) Any post-1986 undistributed earnings (as well as deficits and previously-taxed earnings, if any) and post-1986 foreign income taxes of a noncontrolled section 902 corporation or a controlled foreign corporation in a pre-2007 separate category for passive income, certain dividends from a DISC or former DISC, taxable income attributable to certain foreign trade income, or certain distributions from a FSC or former FSC shall be allocated to the post-2006 separate category for passive category income.

(*2*) Any post-1986 undistributed earnings (as well as deficits and previously-taxed earnings, if any) and post-1986 foreign income taxes of a noncontrolled section 902 corporation or a controlled foreign corporation in a pre-2007 separate category for financial services income, shipping income or general limitation income shall be allocated to the post-2006 separate category for general category income.

(*3*) Except as provided in paragraph (g)(3)(ii)(B)(*4*) of this section, any post-1986 undistributed earnings (as well as deficits and previously-taxed earnings, if any) and post-1986 foreign income taxes of a noncontrolled section 902 corporation or a controlled foreign corporation in a pre-2007 separate category for high withholding tax interest shall be allocated to the post-2006 separate category for passive category income.

(*4*) If a controlled foreign corporation has positive post-1986 undistributed earnings and post-1986 foreign income taxes in a pre-2007 separate category for high withholding tax interest, such earnings and taxes shall be allocated to the post-2006 separate category for general category income if the earnings would qualify as income subject to high foreign taxes under section 954(b)(4) if the entire amount of post-1986 undistributed earnings were treated as a net item of income subject to the rules of §1.954–1(d). If the high withholding tax interest earnings would not qualify as income subject to high foreign taxes under section 954(b)(4), then the earnings and taxes shall be allocated to the post-2006 separate category for passive category income.

(C) *Interest apportionment safe harbor.* A taxpayer may allocate the post-1986 undistributed earnings (as well as deficits and previously-taxed earnings, if any) and post-1986 foreign income taxes in pre-2007 pools of a controlled foreign corporation or a noncontrolled section 902 corporation following the principles of paragraph (f)(4)(ii) of this section.

(iii) *Consistency rule.* The election to apply a safe harbor method under paragraph (g)(3)(ii) of this section in lieu of the rules described in paragraph (g)(3)(i) of this section may be made on a separate category by separate category basis. However, if a taxpayer elects to apply a safe harbor to allocate pre-2007 pools of more than one pre-2007 separate category of a controlled foreign corporation or a noncontrolled section 902 corporation, such safe harbor (the general safe harbor described in paragraph (g)(3)(ii)(B) of this section

or the interest apportionment safe harbor described in paragraph (g)(3)(ii)(C) of this section) shall apply to allocate post-1986 undistributed earnings (as well as deficits and previously-taxed earnings, if any) and post-1986 foreign income taxes for the pre-2007 pools in each pre-2007 separate category of the foreign corporation for which the taxpayer elected to apply a safe harbor method in lieu of reconstructing the pre-2007 pools.

(4) *Treatment of pre-1987 accumulated profits.* Any pre-1987 accumulated profits (as defined in §1.902–1(a)(10)) of a noncontrolled section 902 corporation or a controlled foreign corporation shall be treated in taxable years beginning after December 31, 2006, as if they had been accumulated during a period in which the rules governing the determination of post-2006 separate categories applied. Foreign income taxes paid, accrued, or deemed paid with respect to such earnings shall be treated as if they were paid, accrued, or deemed paid during a period in which the rules governing the determination of post-2006 separate categories applied as well. The taxpayer must substantiate the post-2006 characterization of the pre-1987 accumulated profits and pre-1987 foreign income taxes in accordance with the rules of paragraph (g)(3) of this section, including the safe harbor provisions. Similar rules shall apply to characterize any deficits or previously-taxed earnings and profits described in section 959(c)(1) and (2) that are attributable to pre-1987 accumulated profits.

(5) *Treatment of earnings and foreign taxes in pre-2007 pools of a lower-tier controlled foreign corporation or noncontrolled section 902 corporation.* The rules of paragraphs (g)(1) through (4) of this section apply to post-1986 undistributed earnings (as well as deficits and previously-taxed earnings, if any) and post-1986 foreign income taxes in pre-2007 pools, and pre-1987 accumulated profits and pre-1987 foreign income taxes, of a lower-tier controlled foreign corporation or noncontrolled section 902 corporation.

(6) *Effective/applicability date.* This paragraph (g) shall apply to taxable years of United States persons and, for purposes of section 906, foreign persons beginning after December 31, 2006 and ending on or after December 21, 2007, and to taxable years of a foreign corporation which end with or within taxable years of its domestic corporate shareholder beginning after December 31, 2006 and ending on or after December 21, 2007.

[T.D. 8214, 53 FR 27034, July 18, 1988, as amended by T.D. 8412, 57 FR 20653, May 14, 1992; T.D. 9260, 71 FR 24533, Apr. 25, 2006; T.D. 9368, 72 FR 72590, Dec. 21, 2007; T.D. 9452, 74 FR 27881, June 11, 2009; T.D. 9521, 76 FR 19272, Apr. 7, 2011]

§ 1.904(b)–0 Outline of regulation provisions.

This section lists the headings for §§1.904(b)–1 and 1.904(b)–2.

§ 1.904(b)–1 Special rules for capital gains and losses.

(a) Capital gains and losses included in taxable income from sources outside the United States.

(1) Limitation on capital gain from sources outside the United States when the taxpayer has net capital losses from sources within the United States.

(i) In general.

(ii) Allocation of reduction to separate categories or rate groups.

(A) In general.

(B) Taxpayer with capital gain rate differential.

(2) Exclusivity of rules; no reduction by reason of net capital loss from sources outside the United States in a different separate category.

(3) Capital losses from sources outside the United States in the same separate category.

(4) Examples.

(b) Capital gain rate differential.

(1) Application of adjustments only if capital gain rate differential exists.

(2) Determination of whether capital gain rate differential exists.

(3) Special rule for certain noncorporate taxpayers.

(c) Rate differential adjustment of capital gains.

(1) Rate differential adjustment of capital gains in foreign source taxable income.

(i) In general.

(ii) Special rule for taxpayers with a net long-term capital loss from sources within the United States.

(iii) Examples.
(2) Rate differential adjustment of capital gains in entire taxable income.
(d) Rate differential adjustment of capital losses from sources outside the United States.
(1) In general.
(2) Determination of which capital gains are offset by net capital losses from sources outside the United States.
(e) Qualified dividend income.
(1) In general.
(2) Exception.
(f) Definitions.
(1) Alternative tax rate.
(2) Net capital gain.
(3) Rate differential portion.
(4) Rate group.
(i) Short-term capital gains or losses.
(ii) Long-term capital gains.
(iii) Long-term capital losses.
(5) Terms used in sections 1(h), 904(b) or 1222.
(g) Examples.
(h) Coordination with section 904(f).
(1) In general.
(2) Examples.
(i) Effective date.

§ 1.904(b)–2 Special rules for application of section 904(b) to alternative minimum tax foreign tax credit.

(a) Application of section 904(b)(2)(B) adjustments.
(b) Use of alternative minimum tax rates.
(1) Taxpayers other than corporations.
(2) Corporate taxpayers.
(c) Effective date.

[T.D. 9371, 72 FR 72596, Dec. 21, 2007]

§ 1.904(b)–1 Special rules for capital gains and losses.

(a) *Capital gains and losses included in taxable income from sources outside the United States*—(1) *Limitation on capital gain from sources outside the United States when the taxpayer has net capital losses from sources within the United States*—(i) *In general.* Except as otherwise provided in this section, for purposes of section 904 and this section, taxable income from sources outside the United States (in all of the taxpayer's separate categories in the aggregate) shall include capital gain net income from sources outside the United States (determined by considering all of the capital gain and loss items in all of the taxpayer's separate categories in the aggregate) only to the extent of capital gain net income from all sources. Thus, capital gain net income from sources outside the United States (determined by considering all of the capital gain and loss items in all of the taxpayer's separate categories in the aggregate) shall be reduced to the extent such amount exceeds capital gain net income from all sources.

(ii) *Allocation of reduction to separate categories or rate groups*—(A) *In general.* If capital gain net income from sources outside the United States exceeds capital gain net income from all sources, and the taxpayer has capital gain net income from sources outside the United States in only one separate category, such excess is allocated as a reduction to that separate category. If a taxpayer has capital gain net income from foreign sources in two or more separate categories, such excess must be apportioned on a pro rata basis as a reduction to each such separate category. For purposes of the preceding sentence, pro rata means based on the relative amounts of the capital gain net income from sources outside the United States in each separate category.

(B) *Taxpayer with capital gain rate differential.* If a taxpayer with a capital gain rate differential for the year (within the meaning of paragraph (b) of this section) has capital gain net income from foreign sources in only one rate group within a separate category, any reduction to such separate category pursuant to paragraph (a)(1)(ii)(A) of this section must be allocated to such rate group. If a taxpayer with a capital gain rate differential for the year (within the meaning of paragraph (b) of this section) has capital gain net income from foreign sources in two or more rate groups within a separate category, any reduction to such separate category pursuant to paragraph (a)(1)(ii)(A) of this section must be apportioned on a pro rata basis among such rate groups. For purposes of the preceding sentence, pro rata means based on the relative amounts of the capital gain net income from sources outside the United States

in each rate group within the applicable separate category.

(2) *Exclusivity of rules; no reduction by reason of net capital losses from sources outside the United States in a different separate category*. Capital gains from sources outside the United States in any separate category shall be limited by reason of section 904(b)(2)(A) and the comparable limitation of section 904(b)(2)(B)(i) only to the extent provided in paragraph (a)(1) of this section (relating to limitation on capital gain from sources outside the United States when taxpayer has net capital losses from sources within the United States).

(3) *Capital losses from sources outside the United States in the same separate category*. Except as otherwise provided in paragraph (d) of this section, taxable income from sources outside the United States in each separate category shall be reduced by any capital loss that is allocable or apportionable to income from sources outside the United States in such separate category to the extent such loss is allowable in determining taxable income for the taxable year.

(4) *Examples*. The following examples illustrate the application of this paragraph (a) to taxpayers that do not have a capital gain rate differential for the taxable year. See paragraph (g) of this section for examples that illustrate the application of this paragraph (a) to taxpayers that have a capital gain rate differential for the year. The examples are as follows:

Example 1. Taxpayer A, a corporation, has a $3,000 capital loss from sources outside the United States in the general limitation category, a $6,000 capital gain from sources outside the United States in the passive category, and a $2,000 capital loss from sources within the United States. A's capital gain net income from sources outside the United States in the aggregate, from all separate categories, is $3,000 ($6,000 − $3,000). A's capital gain net income from all sources is $1,000 ($6,000 − $3,000 − $2,000). Thus, for purposes of section 904, A's taxable income from sources outside the United States in all of A's separate categories in the aggregate includes only $1,000 of capital gain net income from sources outside the United States. See paragraph (a)(1)(i) of this section. Pursuant to paragraphs (a)(1)(i) and (a)(1)(ii)(A) of this section, A must reduce the $6,000 of capital gain net income from sources outside the United States in the passive category by $2,000 ($3,000 of capital gain net income from sources outside the United States − $1,000 of capital gain net income from all sources). After the adjustment, A has $4,000 of capital gain from sources outside the United States in the passive category and $3,000 of capital loss from sources outside the United States in the general limitation category.

Example 2. Taxpayer B, a corporation, has a $300 capital gain from sources outside the United States in the general limitation category and a $200 capital gain from sources outside the United States in the passive category. B's capital gain net income from sources outside the United States is $500 ($300 + $200). B also has a $150 capital loss from sources within the United States and a $50 capital gain from sources within the United States. Thus, B's capital gain net income from all sources is $400 ($300 + $200 − $150 + $50). Pursuant to paragraph (a)(1)(ii)(A) of this section, the $100 excess of capital gain net income from sources outside the United States over capital gain net income from all sources ($500 − $400) must be apportioned, as a reduction, three-fifths ($300/$500 of $100, or $60) to the general limitation category and two-fifths ($200/$500 of $100, or $40) to the passive category. Therefore, for purposes of section 904, the general limitation category includes $240 ($300 − $60) of capital gain net income from sources outside the United States and the passive category includes $160 ($200 − $40) of capital gain net income from sources outside the United States.

Example 3. Taxpayer C, a corporation, has a $10,000 capital loss from sources outside the United States in the general limitation category, a $4,000 capital gain from sources outside the United States in the passive category, and a $2,000 capital gain from sources within the United States. C's capital gain net income from sources outside the United States is zero, since losses exceed gains. C's capital gain net income from all sources is also zero. C's capital gain net income from sources outside the United States does not exceed its capital gain net income from all sources, and therefore paragraph (a)(1) of this section does not require any reduction of C's passive category capital gain. For purposes of section 904, C's passive category includes $4,000 of capital gain net income. C's general limitation category includes a capital loss of $6,000 because only $6,000 of capital loss is allowable as a deduction in the current year. The entire $4,000 of capital loss in excess of the $6,000 of capital loss that offsets capital gain in the taxable year is carried back or forward under section 1212(a), and none of such $4,000 is taken into account under section 904(a) or (b) for the current taxable year.

(b) *Capital gain rate differential*—(1) *Application of adjustments only if capital*

gain rate differential exists. Section 904(b)(2)(B) and paragraphs (c) and (d) of this section apply only for taxable years in which the taxpayer has a capital gain rate differential.

(2) *Determination of whether capital gain rate differential exists.* For purposes of section 904(b) and this section, a capital gain rate differential is considered to exist for the taxable year only if the taxpayer has taxable income (excluding net capital gain and qualified dividend income) for the taxable year, a net capital gain for the taxable year and—

(i) In the case of a taxpayer other than a corporation, tax is imposed on the net capital gain at a reduced rate under section 1(h) for the taxable year; or

(ii) In the case of a corporation, tax is imposed under section 1201(a) on the taxpayer at a rate less than any rate of tax imposed on the taxpayer by section 11, 511, or 831(a) or (b), whichever applies (determined without regard to the last sentence of section 11(b)(1)), for the taxable year.

(3) *Special rule for certain noncorporate taxpayers.* A taxpayer that has a capital gain rate differential for the taxable year under paragraph (b)(2)(i) of this section and is not subject to alternative minimum tax under section 55 for the taxable year may elect not to apply the rate differential adjustments contained in section 904(b)(2)(B) and paragraphs (c) and (d) of this section if the highest rate of tax imposed on such taxpayer's taxable income (excluding net capital gain and any qualified dividend income) for the taxable year under section 1 does not exceed the highest rate of tax in effect under section 1(h) for the taxable year and the amount of the taxpayer's net capital gain from sources outside the United States, plus the amount of the taxpayer's qualified dividend income from sources outside the United States, is less than $20,000. A taxpayer that has a capital gain rate differential for the taxable year under paragraph (b)(2)(i) of this section and is subject to alternative minimum tax under section 55 for the taxable year may make such election if the rate of tax imposed on such taxpayer's alternative minimum taxable income (excluding net capital gain and any qualified dividend income) under section 55 does not exceed 26 percent, the highest rate of tax imposed on such taxpayer's taxable income (excluding net capital gain and any qualified dividend income) for the taxable year under section 1 does not exceed the highest rate of tax in effect under section 1(h) for the taxable year and the amount of the taxpayer's net capital gain from sources outside the United States, plus the amount of the taxpayer's qualified dividend income from sources outside the United States, is less than $20,000. A taxpayer who makes this election shall apply paragraph (a) of this section as if such taxpayer does not have a capital gain rate differential for the taxable year. An eligible taxpayer shall be presumed to have elected not to apply the rate differential adjustments, unless such taxpayer applies the rate differential adjustments contained in section 904(b)(2)(B) and paragraphs (c) and (d) of this section in determining its foreign tax credit limitation for the taxable year.

(c) *Rate differential adjustment of capital gains*—(1) *Rate differential adjustment of capital gains in foreign source taxable income*—(i) *In general.* Subject to paragraph (c)(1)(ii) of this section, in determining taxable income from sources outside the United States for purposes of section 904 and this section, capital gain net income from sources outside the United States in each long-term rate group in each separate category (separate category long-term rate group), shall be reduced by the rate differential portion of such capital gain net income. For purposes of paragraph (c)(1) of this section, references to capital gain net income are references to capital gain net income remaining after any reduction to such income pursuant to paragraph (a)(1) of this section (*i.e.*, paragraph (a)(1) of this section applies before paragraphs (c) and (d) of this section).

(ii) *Special rule for taxpayers with a net long-term capital loss from sources within the United States.* If a taxpayer has a net long-term capital loss from sources within the United States (*i.e.*, the taxpayer's long-term capital losses from sources within the United States exceed the taxpayer's long-term capital

gains from sources within the United States) and also has any short-term capital gains from sources within or without the United States, then capital gain net income from sources outside the United States in each separate category long-term rate group shall be reduced by the rate differential portion of the applicable rate differential amount. The applicable rate differential amount is determined as follows:

(A) *Step 1: Determine the U.S. long-term capital loss adjustment amount*. The U.S. long-term capital loss adjustment amount is the excess, if any, of the net long-term capital loss from sources within the United States over the amount, if any, by which the taxpayer reduced long-term capital gains from sources without the United States pursuant to paragraph (a)(1) of this section.

(B) *Step 2: Determine the applicable rate differential amount*. If a taxpayer has capital gain net income from sources outside the United States in only one separate category long-term rate group, the applicable rate differential amount is the excess of such capital gain net income over the U.S. long-term capital loss adjustment amount. If a taxpayer has capital gain net income from sources outside the United States in more than one separate category long-term rate group, the U.S. long-term capital loss adjustment amount shall be apportioned on a pro rata basis to each separate category long-term rate group with capital gain net income. For purposes of the preceding sentence, pro rata means based on the relative amounts of capital gain net income from sources outside the United States in each separate category long-term rate group. The applicable rate differential amount for each separate category long-term rate group with capital gain net income is the excess of such capital gain net income over the portion of the U.S. long-term capital loss adjustment amount apportioned to the separate category long-term rate group pursuant to this Step 2.

(iii) *Examples*. The following examples illustrate the provisions of paragraph (c)(1)(ii) of this section. The taxpayers in the examples are assumed to have taxable income (excluding net capital gain and qualified dividend income) subject to a rate of tax under section 1 greater than the highest rate of tax in effect under section 1(h) for the applicable taxable year. The examples are as follows:

Example 1. (i) M, an individual, has $300 of long-term capital gain from foreign sources in the passive category, $200 of which is subject to tax at a rate of 15 percent under section 1(h) and $100 of which is subject to tax at a rate of 28% under section 1(h). M has $150 of short-term capital gain from sources within the United States. M has a $100 long-term capital loss from sources within the United States.

(ii) M's capital gain net income from sources outside the United States ($300) does not exceed M's capital gain net income from all sources ($350). Therefore, paragraph (a)(1) of this section does not require any reduction of M's capital gain net income in the passive category.

(iii) Because M has a net long-term capital loss from sources within the United States ($100) and also has a short-term capital gain from U.S. sources ($150), M must apply the provisions of paragraph (c)(1)(ii) of this section to determine the amount of the $300 of capital gain net income in the passive category that is subject to a rate differential adjustment. Under *Step 1*, the U.S. long-term capital loss adjustment amount is $100 ($100 − $0). Under *Step 2*, M must apportion this amount to each rate group in the passive category pro rata based on the amount of capital gain net income in each rate group. Thus, $66.67 ($200/$300 of $100) is apportioned to the 15 percent rate group and $33.33 ($100/$300 of $100) is apportioned to the 28 percent rate group. The applicable rate differential amount for the 15 percent rate group is $133.33 ($200 − $66.67). Thus, $133.33 of the $200 of capital gain net income in the 15 percent rate group is subject to a rate differential adjustment pursuant to paragraph (c)(1) of this section. The remaining $66.67 is not subject to a rate differential adjustment. The applicable rate differential amount for the 28 percent rate group is $66.67 ($100 − $33.33). Thus, $66.67 of the $100 of capital gain net income in the 28 percent rate group is subject to a rate differential adjustment pursuant to paragraph (c)(1) of this section. The remaining $33.33 is not subject to a rate differential adjustment.

Example 2. (i) N, an individual, has $300 of long-term capital gain from foreign sources in the passive category, all of which is subject to tax at a rate of 15 percent under section 1(h). N has $50 of short-term capital gain from sources within the United States. N has a $100 long-term capital loss from sources within the United States.

(ii) N's capital gain net income from sources outside the United States ($300) exceeds N's capital gain net income from all sources ($250). Pursuant to paragraph (a)(1) of this section, N must reduce the $300 capital gain in the passive category by $50. N has $250 of capital gain remaining in the passive category.

(iii) Because N has a net long-term capital loss from sources within the United States ($100) and also has a short-term capital gain from U.S. sources ($50), N must apply the provisions of paragraph (c)(1)(ii) of this section to determine the amount of the $250 of capital gain in the passive category that is subject to a rate differential adjustment. Under *Step 1*, the U.S. long-term capital loss adjustment amount is $50 ($100 − $50). Under *Step 2*, the applicable rate differential amount is $200 ($250 − $50). Thus, $200 of the capital gain in the passive category is subject to a rate differential adjustment under paragraph (c)(1) of this section. The remaining $50 is not subject to a rate differential adjustment.

Example 3. (i) O, an individual, has a $100 short-term capital gain from foreign sources in the passive category. O has $300 of long-term capital gain from foreign sources in the passive category, all of which is subject to tax at a rate of 15 percent under section 1(h). O has a $100 long-term capital loss from sources within the United States.

(ii) O's capital gain net income from sources outside the United States ($400) exceeds O's capital gain net income from all sources ($300). Pursuant to paragraph (a)(1) of this section, O must reduce the $400 capital gain net income in the passive category by $100. Because C has capital gain net income in two or more rate groups in the passive category, O must apportion such amount, as a reduction, to each rate group on a pro rata basis pursuant to paragraph (a)(1)(ii)(B) of this section. Thus, $25 ($100/$400 of $100) is apportioned to the short-term capital gain and $75 ($300/$400 of $100) is apportioned to the long-term capital gain in the 15 percent rate group. After application of paragraph (a)(1) of this section, O has $75 of short-term capital gain in the passive category and $225 of long-term capital gain in the 15 percent rate group in the passive category.

(iii) Because O has a net long-term capital loss from sources within the United States ($100) and also has a short-term capital gain from foreign sources ($100), O must apply the provisions of paragraph (c)(1)(ii) of this section to determine the amount of the $225 of long-term capital gain in the 15 percent rate group that is subject to a rate differential adjustment. Under *Step 1*, the U.S. long-term capital loss adjustment amount is $25 ($100 − $75). Under *Step 2*, the applicable rate differential amount is $200 ($225 − $25). Thus, $200 of the long-term capital gain is subject to a rate differential adjustment under paragraph (c)(1) of this section. The remaining $25 of long-term capital gain is not subject to a rate differential adjustment.

(2) *Rate differential adjustment of capital gains in entire taxable income.* For purposes of section 904 and this section, entire taxable income shall include gains from the sale or exchange of capital assets only to the extent of capital gain net income reduced by the sum of the rate differential portions of each rate group of net capital gain.

(d) *Rate differential adjustment of capital losses from sources outside the United States*—(1) *In general.* In determining taxable income from sources outside the United States for purposes of section 904 and this section, a taxpayer with a net capital loss in a separate category rate group shall reduce such net capital loss by the sum of the rate differential portions of the capital gain net income in each long-term rate group offset by such net capital loss. A net capital loss in a separate category rate group is the amount, if any, by which capital losses in a rate group from sources outside the United States included in a separate category exceed capital gains from sources outside the United States in the same rate group and the same separate category.

(2) *Determination of which capital gains are offset by net capital losses from sources outside the United States.* For purposes of paragraph (d)(1) of this section, in order to determine the capital gain net income offset by net capital losses from sources outside the United States, the following rules shall apply in the following order:

(i) Net capital losses from sources outside the United States in each separate category rate group shall be netted against capital gain net income from sources outside the United States from the same rate group in other separate categories.

(ii) Capital losses from sources within the United States shall be netted against capital gains from sources within the United States in the same rate group.

(iii) Net capital losses from sources outside the United States in excess of the amounts netted against capital gains under paragraph (d)(2)(i) of this

section shall be netted against the taxpayer's remaining capital gains from sources within and outside the United States in the following order, and without regard to any net capital losses, from any rate group, from sources within the United States—

(A) First against capital gain net income from sources within the United States in the same rate group;

(B) Next, against capital gain net income in other rate groups, in the order in which capital losses offset capital gains for purposes of determining the taxpayer's taxable income and without regard to whether such capital gain net income derives from sources within or outside the United States, as follows:

(*1*) A net capital loss in the short-term rate group is used first to offset any capital gain net income in the 28 percent rate group, then to offset capital gain net income in the 25 percent rate group, then to offset capital gain net income in the 15 percent rate group, and finally to offset capital gain net income in the 5 percent rate group.

(*2*) A net capital loss in the 28 percent rate group is used first to offset capital gain net income in the 25 percent rate group, then to offset capital gain net income in the 15 percent rate group, and finally to offset capital gain net income in the 5 percent rate group.

(*3*) A net capital loss in the 15 percent rate group is used first to offset capital gain net income in the 5 percent rate group, and then to offset capital gain net income in the 28 percent rate group, and finally to offset capital gain net income in the 25 percent rate group.

(iv) Net capital losses from sources outside the United States in any rate group, to the extent netted against capital gains in any other separate category under paragraph (d)(2)(i) of this section or against capital gains in the same or any other rate group under paragraph (d)(2)(iii) of this section, shall be treated as coming pro rata from each separate category that contains a net capital loss from sources outside the United States in that rate group. For example, assume that the taxpayer has $20 of net capital losses in the 15 percent rate group in the passive category and $40 of net capital losses in the 15 percent rate group in the general limitation category, both from sources outside the United States. Further assume that $50 of the total $60 net capital losses from sources outside the United States are netted against capital gain net income in the 28 percent rate group (from other separate categories or from sources within the United States). One-third of the $50 of such capital losses would be treated as coming from the passive category, and two-thirds of such $50 would be treated as coming from the general limitation category.

(v) In determining the capital gain net income offset by a net capital loss from sources outside the United States pursuant to this paragraph (d)(2), a taxpayer shall take into account any reduction to capital gain net income from sources outside the United States pursuant to paragraph (a) of this section and shall disregard any adjustments to such capital gain net income pursuant to paragraph (c)(1) of this section.

(vi) If at any time during a taxable year, tax is imposed under section 1(h) at a rate other than a rate of tax specified in this paragraph (d)(2), the principles of this paragraph (d)(2) shall apply to determine the capital gain net income offset by any net capital loss in a separate category rate group.

(vii) The determination of which capital gains are offset by capital losses from sources outside the United States under this paragraph (d)(2) is made solely in order to determine the appropriate rate-differential-based adjustments to such capital losses under this section and section 904(b), and does not change the source, allocation, or separate category of any such capital gain or loss for purposes of computing taxable income from sources within or outside the United States or for any other purpose.

(e) *Qualified dividend income*—(1) *In general*. A taxpayer that has taxable income (excluding net capital gain and qualified dividend income) for the taxable year and that qualifies for a reduced rate of tax under section 1(h) on its qualified dividend income (as defined in section 1(h)(11)) for the taxable year shall adjust the amount of such qualified dividend income in a manner consistent with the rules of paragraphs

(c)(1)(i) (first sentence) and (c)(2) of this section irrespective of whether such taxpayer has a net capital gain for the taxable year. For purposes of making adjustments pursuant to this paragraph (e), the special rule in paragraph (c)(1)(ii) of this section for taxpayers with a net long-term capital loss from sources within the United States shall be disregarded.

(2) *Exception*. A taxpayer that makes the election provided for in paragraph (b)(3) of this section shall not make adjustments pursuant to paragraph (e)(1) of this section. Additionally, a taxpayer other than a corporation that does not have a capital gain rate differential for the taxable year within the meaning of paragraph (b)(2) of this section may elect not to apply paragraph (e)(1) of this section if such taxpayer would have qualified for the election provided for in paragraph (b)(3) of this section had such taxpayer had a capital gain rate differential for the taxable year. Such a taxpayer shall be presumed to make the election provided for in the preceding sentence unless such taxpayer applies the rate differential adjustments provided for in paragraph (e)(1) of this section to the qualified dividend income in determining its foreign tax credit limitation for the taxable year.

(f) *Definitions*. For purposes of section 904(b) and this section, the following definitions apply:

(1) *Alternative tax rate*. The term *alternative tax rate* means, with respect to any rate group, the rate applicable to that rate group under section 1(h) (for taxpayers other than corporations) or section 1201(a) (for corporations). For example, the alternative tax rate for unrecaptured section 1250 gain is 25 percent.

(2) *Net capital gain*. For purposes of this section, net capital gain shall not include any qualified dividend income (as defined in section 1(h)(11)). See paragraph (e) of this section for rules relating to qualified dividend income.

(3) *Rate differential portion*. The term *rate differential portion* with respect to capital gain net income from sources outside the United States in a separate category long-term rate group (or the applicable portion of such amount), net capital gain in a rate group, or capital gain net income in a long-term rate group, as the case may be, means the same proportion of such amount as—

(i) The excess of the highest applicable tax rate (as defined in section 904(b)(3)(E)(ii)) over the alternative tax rate; bears to

(ii) The highest applicable tax rate (as defined in section 904(b)(3)(E)(ii)).

(4) *Rate group*. For purposes of this section, the term *rate group* means:

(i) *Short-term capital gains or losses*. With respect to a short-term capital gain or loss, the rate group is the short-term rate group.

(ii) *Long-term capital gains*. With respect to a long-term capital gain, the rate group is the particular rate of tax to which such gain is subject under section 1(h). Such a rate group is a long-term rate group. For example, the 28 percent rate group of capital gain net income from sources outside the United States consists of the capital gain net income from sources outside the United States that is subject to tax at a rate of 28 percent under section 1(h). Such 28 percent rate group is a long-term rate group. If a taxpayer has long-term capital gains that may be subject to tax at more than one rate under section 1(h) and the taxpayer's net capital gain attributable to such long-term capital gains and any qualified dividend income are taxed at one rate of tax under section 1(h), then all of such long-term capital gains shall be treated as long-term capital gains in that one rate group. If a taxpayer has long-term capital gains that may be subject to tax at more than one rate of tax under section 1(h) and the taxpayer's net capital gain attributable to such long-term capital gains and any qualified dividend income are taxed at more than one rate pursuant to section 1(h), the taxpayer shall determine the rate group for such long-term capital gains from sources within or outside the United States (and, to the extent from sources outside the United States, from each separate category) ratably based on the proportions of net capital gain and any qualified dividend income taxed at each applicable rate. For example, under the section 1(h) rates in effect for tax years beginning in 2004, a long-term capital gain (other than a

long-term capital gain described in section 1(h)(4)(A) or (h)(6)) may be subject to tax at 5 percent or 15 percent.

(iii) *Long-term capital losses.* With respect to a long-term capital loss, a loss described in section 1(h)(4)(B)(i) (collectibles loss) or (iii) (long-term capital loss carryover) is a loss in the 28 percent rate group. All other long-term capital losses shall be treated as losses in the highest rate group in effect under section 1(h) for the tax year with respect to long-term capital gains other than long-term capital gains described in section 1(h)(4)(A) or (h)(6). For example, under the section 1(h) rates in effect for tax years beginning in 2004, a long-term capital loss not described in section 1(h)(4)(B)(i) or (iii) shall be treated as a loss in the 15 percent rate group.

(5) *Terms used in sections 1(h), 904(b) or 1222.* For purposes of this section, any term used in this section and also used in section 1(h), section 904(b) or section 1222 shall have the same meaning given such term by section 1(h), 904(b) or 1222, respectively, except as otherwise provided in this section.

(g) *Examples.* The following examples illustrate the provisions of this section. In these examples, the rate differential adjustment is shown as a fraction, the numerator of which is the alternative tax rate percentage and the denominator of which is 35 percent (assumed to be the highest applicable tax rate for individuals under section 1). Finally, all dollar amounts in the examples are abbreviated from amounts in the thousands (for example, $50 represents $50,000). The examples are as follows:

Example 1. (i) AA, an individual, has items from sources outside the United States only in the passive category for the taxable year. AA has $1000 of long-term capital gains from sources outside the United States that are subject to tax at a rate of 15 percent under section 1(h). AA has $700 of long-term capital losses from sources outside the United States, which are not described in section 1(h)(4)(B)(i) or (iii). For the same taxable year, AA has $800 of long-term capital gains from sources within the United States that are taxed at a rate of 28 percent under section 1(h). AA also has $100 of long-term capital losses from sources within the United States, which are not described in section 1(h)(4)(B)(i) or (iii). AA also has $500 of ordinary income from sources within the United States. The highest tax rate in effect under section 1(h) for the taxable year with respect to long-term capital gains other than long-term capital gains described in section 1(h)(4)(A) or (h)(6) is 15 percent. Accordingly, AA's long-term capital losses are in the 15 percent rate group.

(ii) AA's items of ordinary income, capital gain and capital loss for the taxable year are summarized in the following table:

	U.S. source	Foreign source: passive
15% rate group	($100)	$1,000
		(700)
28% rate group	800	
Ordinary income	500	

(iii) AA's capital gain net income from sources outside the United States ($300) does not exceed AA's capital gain net income from all sources ($1,000). Therefore, paragraph (a)(1) of this section does not require any reduction of AA's capital gain net income in the passive category.

(iv) In computing AA's taxable income from sources outside the United States in the numerator of the section 904(a) foreign tax credit limitation fraction for the passive category, AA's $300 of capital gain net income in the 15 rate group in the passive category must be adjusted as required under paragraph (c)(1) of this section. AA adjusts the $300 of capital gain net income using 15 percent as the alternative tax rate, as follows: $300 (15%/35%).

(v) In computing AA's entire taxable income in the denominator of the section 904(a) foreign tax credit limitation fraction, AA combines the $300 of capital gain net income from sources outside the United States and the $100 net capital loss from sources within the United States in the same rate group (15 percent). AA must adjust the resulting $200 ($300 − $100) of net capital gain in the 15 percent rate group as required under paragraph (c)(2) of this section, using 15 percent as the alternative tax rate, as follows: $200 (15%/35%). AA must also adjust the $800 of net capital gain in the 28 percent rate group, using 28 percent as the alternative tax rate, as follows: $800 (28%/35%). AA must also include ordinary income from sources outside the United States in the numerator, and ordinary income from all sources in the denominator, of the foreign tax credit limitation fraction.

(vi) AA's passive category foreign tax credit limitation fraction is $128.58/$1225.72, computed as follows:

$$\frac{\$300\ (15\%/35\%)}{\$500 + \$200\ (15\%/35\%) + \$800\ (28\%/35\%)}$$

Example 2. (i) BB, an individual, has the following items of ordinary income, capital gain, and capital loss for the taxable year:

	U.S. source	Foreign source	
		General	Passive
15% rate group	$300	($500)	$100
25% rate group	200		
28% rate group	500	(300)	
Ordinary income	1,000	500	500

(ii) BB's capital gain net income from sources outside the United States in the aggregate (zero, since losses exceed gains) does not exceed BB's capital gain net income from all sources ($300). Therefore, paragraph (a)(1) of this section does not require any reduction of BB's capital gain net income in the passive category.

(iii) In computing BB's taxable income from sources outside the United States in the numerators of the section 904(a) foreign tax credit limitation fractions for the passive and general limitation categories, BB must adjust capital gain net income from sources outside the United States in each separate category long-tem rate group and net capital losses from sources outside the United States in each separate category rate group as provided in paragraphs (c)(1) and (d) of this section.

(A) The $100 of capital gain net income in the 15 percent rate group in the passive category is adjusted under paragraph (c)(1) of this section as follows: $100 (15%/35%).

(B) BB must adjust the net capital losses in the 15 percent and 28 percent rate groups in the general limitation category in accordance with the ordering rules contained in paragraph (d)(2) of this section. Under paragraph (d)(2)(i) of this section, BB's net capital loss in the 15 percent rate group is netted against capital gain net income from sources outside the United States in other separate categories in the same rate group. Thus, $100 of the $500 net capital loss in the 15 percent rate group in the general limitation category offsets $100 of capital gain net income in the 15 percent rate group in the passive category. Accordingly, $100 of the $500 net capital loss is adjusted under paragraph (d)(1) of this section as follows: $100 (15%/35%).

(C) Next, under paragraph (d)(2)(iii)(A) of this section, BB's net capital losses from sources outside the United States in any separate category rate group are netted against capital gain net income in the same rate group from sources within the United States. Thus, $300 of the $500 net capital loss in the 15 percent rate group in the general limitation category offsets $300 of capital gain net income in the 15 percent rate group from sources within the United States. Accordingly, $300 of the $500 net capital loss is adjusted under paragraph (d)(1) of this section as follows: $300 (15%/35%). Similarly, the $300 of net capital loss in the 28 percent rate group in the general limitation category offsets $300 of capital gain net income in the 28 percent rate group from sources within the United States. The $300 net capital loss is adjusted under paragraph (d)(1) of this section as follows: $300 (28%/35%).

(D) Finally, under paragraph (d)(2)(iii)(B) of this section, the remaining net capital losses in a separate category rate group are netted against capital gain net income from other rate groups from sources within and outside the United States. Thus, the remaining $100 of the $500 net capital loss in the 15 percent rate group in the general limitation category offsets $100 of the remaining capital gain net income in the 28 percent rate group from sources within the United States. Accordingly, the remaining $100 of net capital loss is adjusted under paragraph (d)(1) of this section as follows: $100 (28%/35%).

(iv) In computing BB's entire taxable income in the denominator of the section 904(a) foreign tax credit limitation fractions, BB must adjust net capital gain by netting all of BB's capital gains and losses, from sources within and outside the United States, and adjusting any remaining net capital gains, based on rate group, under paragraph (c)(2) of this section. BB must also include foreign source ordinary income in the numerators, and ordinary income from all sources in the denominator, of the foreign tax credit limitation fractions. The denominator of BB's foreign tax credit limitation fractions reflects $2,000 of ordinary income from all sources, $100 of net capital gain

taxed at the 28% rate and adjusted as follows: $100 (28%/35%), and $200 of net capital gain taxed at the 25% rate and adjusted as follows: $200 (25%/35%).

(v) BB's foreign tax credit limitation fraction for the general limitation category is $8.56/$2222.86, computed as follows:

$$\frac{\$500 - \$100\ (15\%/35\%) - \$300\ (15\%/35\%) - \$300\ (28\%/35\%) - \$100\ (28\%/35\%)}{\$1{,}000 + \$500 + \$500 + \$100\ (28\%/35\%) + \$200\ (25\%/35\%)}$$

(vi) BB's foreign tax credit limitation fraction for the passive category is $542.86/$2222.86, computed as follows:

$$\frac{\$500 + \$100\ (15\%/35\%)}{\$1{,}000 + \$500 + \$500 + \$100\ (28\%/35\%) + \$200\ (25\%/35\%)}$$

Example 3. (i) CC, an individual, has the following items of ordinary income, capital gain, and capital loss for the taxable year:

	U.S. source	Foreign source	
		General	Passive
15% rate group	$300	($720)	($80)
25% rate group	200	.....	.....
28% rate group	500	(150)	50
Ordinary income	1,000	1,000	500

(ii) CC's capital gain net income from sources outside the United States (zero, since losses exceed gains) does not exceed CC's capital gain net income from all sources ($100). Therefore, paragraph (a)(1) of this section does not require any adjustment.

(iii) In computing CC's taxable income from sources outside the United States in the numerators of the section 904(a) foreign tax credit limitation fractions for the passive and general limitation categories, CC must adjust capital gain net income from sources outside the United States in each separate category long-tem rate group and net capital losses from sources outside the United States in each separate category rate group as provided in paragraphs (c)(1) and (d) of this section.

(A) CC must adjust the $50 of capital gain net income in the 28 percent rate group in the passive category pursuant to paragraph (c)(1) of this section as follows: $50 (28%/35%).

(B) Under paragraph (d)(2)(i) of this section, $50 of CC's $150 net capital loss in the 28 percent rate group in the general limitation category offsets $50 of capital gain net income in the 28 percent rate group in the passive category. Thus, $50 of the $150 net capital loss is adjusted as follows: $50 (28%/35%). Next, under paragraph (d)(2)(iii)(A) of this section, the remaining $100 of net capital loss in the 28 percent rate group in the general limitation category offsets $100 of capital gain net income in the 28 percent rate group from sources within the United States. Thus, the remaining $100 of net capital loss is adjusted as follows: $100 (28%/35%).

(C) Under paragraphs (d)(2)(iii)(A) and (d)(2)(iv) of this section, the net capital losses in the 15 percent rate group in the passive and general limitation categories offset on a pro rata basis the $300 of capital gain net income in the 15 percent rate group from sources within the United States. The proportionate amount of the $720 net capital loss ($720/$800 of $300, or $270) is adjusted as follows: $270 (15%/35%). The proportionate amount of the $80 net capital loss ($80/$800 of $300, or $30) is adjusted as follows $30 (15%/35%).

(D) Of the remaining $500 of net capital loss in the 15 percent rate group in the general limitation and passive categories, $400 offsets the remaining $400 of capital gain net income in the 28 percent rate group from sources within the United States under paragraph (d)(2)(iii)(B)(*3*) of this section. The proportionate amount of the $720 net capital loss ($720/$800 of $400, or $360) is adjusted as follows: $360 (28%/35%). The proportionate

amount of the $80 net capital loss ($80/$800 of $400, or $40) is adjusted as follows: $40 (28%/35%).

(E) Under paragraph (d)(2)(iii)(B)(*3*) of this section, the remaining $100 of net capital loss in the 15 percent rate group in the general limitation and passive limitation categories offsets $100 of capital gain net income in the 25 percent rate group from sources within the United States. The proportionate amount of the $720 net capital loss ($720/$800 of $100, or $90) is adjusted as follows: $90 (25%/35%). The proportionate amount of the $80 net capital loss ($80/$800 of $100 of $10) is adjusted as follows: $10 (25%/35%).

(iv) In computing CC's entire taxable income in the denominator of the section 904(a) foreign tax credit limitation fractions, CC must adjust capital gain net income by netting all of CC's capital gains and losses, from sources within and outside the United States, and adjusting any remaining net capital gains, based on rate group, under paragraph (c)(2) of this section. The denominator of CC's foreign tax credit limitation fractions reflects $2,500 of ordinary income from all sources and $100 of net capital gain taxed at the 25% rate and adjusted as follows: $100 (25%/35%).

(v) CC's foreign tax credit limitation fraction for the general limitation category is $412/$2571.42, computed as follows:

$$\frac{\$1{,}000 - \$50\ (28\%/35\%) - \$100\ (28\%/35\%) - \$270\ (15\%/35\%) - \$360\ (28\%/35\%) - \$90\ (25\%/35\%)}{\$1{,}000 + \$1{,}000 + \$500 + \$100\ (25\%/35\%)}$$

(vi) CC's foreign tax credit limitation fraction for the passive category is $488.00/$2571.42, computed as follows:

$$\frac{\$500 + \$50\ (28\%/35\%) - \$30\ (15\%/35\%) - \$40\ (28\%/35\%) - \$10\ (25\%/35\%)}{\$1{,}000 + \$1{,}000 + \$500 + \$100\ (25\%/35\%)}$$

Example 4. (i) DD, an individual, has the following items of ordinary income, capital gain and capital loss for the taxable year:

	U.S. source	Foreign source	
		General	Passive
15% rate group	($80)	($100)	$300
Short-term	.....	500	100
Ordinary income	500	.....	.....

(ii) DD's capital gain net income from outside the United States ($800) exceeds DD's capital gain net income from all sources ($720). Pursuant to paragraph (a)(1)(ii)(A) of this section, DD must apportion the $80 of excess of capital gain net income from sources outside the United States between the general limitation and passive categories based on the amount of capital gain net income in each separate category. Thus, one-half ($400/$800 of $100, or $40) is apportioned to the general limitation category and one-half ($400/$800 of $80, or $40) is apportioned to the passive category. The $40 apportioned to the general limitation category reduces DD's $500 short-term capital gain in the general limitation category to $460. Pursuant to paragraph (a)(1)(ii)(B) of this section, the $40 apportioned to the passive category must be apportioned further between the capital gain net income in the short-term rate group and the 15 percent rate group based on the relative amounts of capital gain net income in each rate group. Thus, one-fourth ($100/$400 of $40 or $10) is apportioned to the short-term rate group and three-fourths ($300/$400 of $40 or $30) is apportioned to the 15 percent rate group. DD's passive category includes $90 of short-term capital gain and $270 of capital gain net income in the 15% rate group.

(iii) Because DD has a net long-term capital loss from sources within the United States ($80) and also has short-term capital gains, DD must apply the provisions of paragraph (c)(1)(ii) of this section to determine the amount of DD's $270 of capital gain net income in the 15% rate group that is subject

to a rate differential adjustment under paragraph (c)(1) of this section. Under *Step 1*, the U.S. long-term capital loss adjustment amount is $50 ($80-$30). Under *Step 2*, the applicable rate differential amount is the excess of the remaining capital gain net income over the U.S. long-term adjustment amount. Thus, the applicable rate differential amount is $220 ($270 − $50). In computing DD's taxable income from sources outside the United States in the numerator of the section 904(a) foreign tax credit limitation fraction for the passive category, DD must adjust this amount as follows: $220 (15%/35%). DD does not adjust the remaining $50 of capital gain net income in the 15% rate group.

(iv) The amount of capital gain net income in the 15% rate group in the passive category, taking into account the adjustment pursuant to paragraph (a)(1) of this section and disregarding the adjustment pursuant to paragraph (c)(1) of this section, is $270. Under paragraphs (d)(2)(i) and (d)(2)(v) of this section, DD's $100 net capital loss in the 15% rate group in the general limitation category offsets capital gain net income in the 15% rate group in the passive category. Accordingly, the $100 of net capital loss is adjusted as follows: $100 (15%/35%).

(v) In computing DD's entire taxable income in the denominator of the section 904(a) foreign tax credit limitation fractions, DD must adjust capital gain net income by netting all of DD's capital gains and losses from sources within and outside the United States, and adjusting the remaining net capital gain in each rate group pursuant to paragraph (c)(2) of this section. The denominator of DD's foreign tax credit limitation fraction reflects $500 of ordinary income from all sources, $600 of short-term capital gain and $120 of net capital gain in the 15 percent rate group adjusted as follows: $120 (15%/35%).

(vi) DD's foreign tax credit limitation fraction for the general limitation category is $417.14/$1151.43, computed as follows:

$$\frac{\$460 - \$100\ (15\%/35\%)}{\$500 + \$600 + \$120\ (15\%/35\%)}$$

(vii) DD's foreign tax credit limitation fraction for the passive category is $234.29/$1151.43, computed as follows:

$$\frac{\$90 + \$220\ (15\%/35\%) + \$50}{\$500 + \$600 + \$120\ (15\%/35\%)}$$

Example 5. (i) EE, an individual, has the following items of ordinary income, capital gain and capital loss for the taxable year:

	U.S. source	Foreign source
		Passive
15% rate group	($150)	$300
28% rate group	.....	200
Short-term	30	100
Ordinary income	500	.....

(ii) EE's capital gain net income from sources outside the United States ($600) exceeds EE's capital gain net income from all sources ($480). Pursuant to paragraph (a)(1)(ii) of this section, the $120 of excess capital gain net income from sources outside the United States is allocated as a reduction to the passive category and must be apportioned pro rata to each rate group within the passive category with capital gain net income. Thus, $20 ($100/$600 of $120) is apportioned to the short-term rate group, $60 ($300/$600 of $120) is apportioned to the 15 percent rate group and $40 ($200/$600 of $120) is apportioned to the 28 percent rate group. After application of paragraph (a)(1) of this section, EE has $80 of capital gain net income in the short-term rate group, $240 of capital gain net income in the 15 percent rate group and $160 of capital gain net income in the 28 percent rate group.

(iii) Because EE has a net long-term capital loss from sources within the United States ($150) and also has short-term capital gains, EE must apply the provisions of paragraph (c)(1)(ii) of this section to determine the amount of EE's remaining $400 ($240 + $160) of capital gain net income in long-term rate groups in the passive category that is subject to a rate differential adjustment to a rate differential adjustment. Under *Step 1*, the U.S. long-term capital loss adjustment amount is $50 ($150-$100). Under *Step 2*, EE must apportion this amount pro rata to each long-term rate group within the passive category with capital gain net income. Thus, $30 ($240/$400 of $50) is apportioned to the 15 percent rate group and $20 ($160/$400 of $50) is apportioned to the 28 percent rate group. The applicable rate differential amount for the 15 percent rate group is $210 ($240 − $30). The applicable rate differential amount for the 28 percent rate group is $140 ($160 − $20).

(iv) Pursuant to paragraph (c)(1)(ii) of this section, EE must adjust $210 of the $240 capital gain in the 15 percent rate group as follows: $210 (15%/35%). EE does not adjust the remaining $30. Pursuant to paragraph (c)(1)(ii) of this section, EE must adjust $140 of the $160 capital gain in the 28 percent rate group as follows: $140 (28%/35%). EE does not adjust the remaining $20.

(v) In computing EE's entire taxable income in the denominator of the section 904(a) foreign tax credit limitation fractions, EE must adjust capital gain net income by netting all of EE's capital gains and losses from sources within and outside the United

States, and adjusting the remaining net capital gain in each rate group pursuant to paragraph (c)(2) of this section. The denominator of EE's foreign tax credit limitation fraction reflects $500 of ordinary income from all sources, $130 of short-term capital gain, $150 of net capital gain in the 15 percent rate group adjusted as follows: $150 (15%/35%), and $200 of net capital gain in the 28 percent rate group adjusted as follows: $200 (28%/35%).

(vi) EE's foreign tax credit limitation fraction for the passive category is $332/$854.29, computed as follows:

$$\frac{\$80+\$210\ (15\%/35\%)+\$30+\$140\ (28\%/35\%)+\$20}{\$500+\$130+\$150\ (15\%/35\%)+\$200\ (28\%/35\%)}$$

(h) *Coordination with section 904(f)*—(1) *In general.* Section 904(b) and this section shall apply before the provisions of section 904(f) as follows:

(i) The amount of a taxpayer's separate limitation income or loss in each separate category, the amount of overall foreign loss, and the amount of any additions to or recapture of separate limitation loss or overall foreign loss accounts pursuant to section 904(f) shall be determined after applying paragraphs (a), (c)(1), (d) and (e) of this section to adjust capital gains and losses and qualified dividend income from sources outside the United States in each separate category.

(ii) To the extent a capital loss from sources within the United States reduces a taxpayer's foreign source taxable income under paragraph (a)(1) of this section, such capital loss shall be disregarded in determining the amount of a taxpayer's taxable income from sources within the United States for purposes of computing the amount of any additions to the taxpayer's overall foreign loss accounts.

(iii) In determining the amount of a taxpayer's loss from sources in the United States under section 904(f)(5)(D) (section 904(f)(5)(D) amount), the taxpayer shall make appropriate adjustments to capital gains and losses from sources within the United States to reflect adjustments pursuant to section 904(b)(2) and this section. Therefore, for purposes of section 904, a taxpayer's section 904(f)(5)(D) amount shall be equal to the excess of the taxpayer's foreign source taxable income in all separate categories in the aggregate for the taxable year (taking into account any adjustments pursuant to paragraphs (a)(1), (c)(1), (d) and (e) of this section) over the taxpayer's entire taxable income for the taxable year (taking into account any adjustments pursuant to paragraphs (c)(2) and (e) of this section).

(2) *Examples.* The following examples illustrate the application of paragraph (h) of this section:

Example 1. (i) W, an individual, has the following items of ordinary income, capital gain, and capital loss for the taxable year:

	U.S. source	Foreign source	
		General	Passive
15% rate group	$500	$100	($400)
Ordinary income	900	100	.....

(ii) In computing W's taxable income from sources outside the United States for purposes of section 904 and this section, W must adjust the capital gain net income and net capital loss in each separate category as provided in paragraphs (c)(1) and (d) of this section. Thus, W must adjust the $100 of capital gain net income in the general limitation category and the $400 of net capital loss in the passive category as follows: $100 (15%/35%) and $400 (15%/35%).

(iii) After the adjustment to W's net capital loss in the passive category, W has a $171.43 separate limitation loss in the passive category. After the adjustment to W's capital gain in the general limitation category, W has $142.86 of foreign source taxable income in the general limitation category. Thus, $142.86 of the separate limitation loss

reduces foreign source taxable income in the general limitation category. See section 904(f)(5)(B). W adds $142.86 to the separate limitation loss account for the passive category. The remaining $28.57 of the separate limitation loss reduces income from sources within the United States. See section 904(f)(5)(A). Thus, W adds $28.57 to the overall foreign loss account for the passive category.

Example 2. (i) X, a corporation, has the following items of ordinary income, ordinary loss, capital gain and capital loss for the taxable year: foreign source:

	U.S. source	Foreign source: general
Capital gain	($500)	$700
Ordinary income	1100	(1000)

(ii) X's capital gain net income from sources outside the United States ($700) exceeds X's capital gain net income from all sources ($200). Pursuant to paragraph (a)(1) of this section, X must reduce the $700 capital gain in the general limitation category by $500. After the adjustment, X has $200 of capital gain net income remaining in the general limitation category. Thus, X has an overall foreign loss attributable to the general limitation category of $800.

(iii) For purposes of computing the amount of the addition to X's overall foreign loss account for the general limitation category, the $500 capital loss from sources within the United States is disregarded and X's taxable income from sources within the United States is $1100. Accordingly, X must increase its overall foreign loss account for the general limitation category by $800.

Example 3. (i) Y, a corporation, has the following items of ordinary income, ordinary loss, capital gain and capital loss for the taxable year:

	U.S. source	Foreign source: passive
Capital gain	($100)	$200
Ordinary income	(200)	500

(ii) Y's capital gain net income from sources outside the United States ($200) exceeds Y's capital gain net income from all sources ($100). Pursuant to paragraph (a)(1) of this section, Y must reduce the $200 capital gain in the passive category by $100. Y has $100 of capital gain net income remaining in the passive category.

(iii) Y is not required to make adjustments pursuant to paragraph (c), (d) or (e) of this section. See paragraphs (b) and (e) of this section. Y's foreign source taxable income in the passive category after the adjustment pursuant to paragraph (a)(1) of this section is $600. Y's entire taxable income for the taxable year is $400.

(iv) Y's section 904(f)(5)(D) amount is the excess of Y's foreign source taxable income in all separate categories in the aggregate for the taxable year after taking into account the adjustment pursuant to paragraph (a)(1) of this section ($600) over Y's entire taxable income for the taxable year ($400). Therefore, Y's section 904(f)(5)(D) amount is $200 and Y's foreign source taxable income in the passive category is reduced to $400. See section 904(f)(5)(D).

Example 4. (i) Z, an individual, has the following items of ordinary income, ordinary loss and capital gain for the taxable year:

	U.S. source	Foreign source:	
		General	Passive
15% rate group	$100	.....	.....
Ordinary income	(200)	$300	$300

(ii) Z's foreign source taxable income in all of Z's separate categories in the aggregate for the taxable year is $600. (There are no adjustments to Z's foreign source taxable income pursuant to paragraph (a)(1), (c)(1), (d) or (e) of this section.)

(iii) In computing Z's entire taxable income in the denominator of the section 904(d) foreign tax credit limitation fractions, Z must adjust the $100 of net capital gain in the 15 percent rate group pursuant to paragraph (c)(2) of this section as follows: $100 (15%/35%). Thus, Z's entire taxable income for the taxable year, taking into account the adjustment pursuant to paragraph (c)(2) of this section, is $442.86.

(iv) Z's section 904(f)(5)(D) amount is the excess of Z's foreign source taxable income in all separate categories in the aggregate for the taxable year ($600) over Z's entire taxable income for the taxable year after the adjustment pursuant to paragraph (c)(2) of this section ($442.86). Therefore, Z's section 904(f)(5)(D) amount is $157.32. This amount must be allocated pro rata to the passive and general limitation categories in accordance with section 904(f)(5)(D).

Example 5. (i) O, an individual, has the following items of ordinary income, ordinary loss and capital gain for the taxable year:

	U.S. source	Foreign source	
		General	Passive
15% rate group	$1100	($500)	.....
Ordinary income	(1000)	1000	$500

(ii) In determining O's taxable income from sources outside the United States, O must reduce the $500 capital loss in the general limitation category to $214.29 ($500 × 15%/35%) pursuant to paragraph (d) of this section. Taking this adjustment into account, O's foreign source taxable income in all of O's separate categories in the aggregate is $1285.71 ($1000 − $214.29 + $500).

(iii) In computing O's entire taxable income in the denominator of the section 904(a) foreign tax credit limitation fraction, O must reduce the $600 of net capital gain for the year to $257.14 ($600 × 15%/35%) pursuant to paragraph (c)(2) of this section. Taking this adjustment into account, O's entire taxable income for the year is $757.14 ($500 + $257.14).

(iv) Therefore, O's section 904(f)(5)(D) amount is $528.57 ($1285.71 − $757.14). This amount must be allocated pro rata to O's $500 of income in the passive category and O's $785.71 of adjusted income in the general limitation category in accordance with section 904(f)(5)(D).

(i) *Effective date*. This section shall apply to taxable years beginning after July 20, 2004. Taxpayers may choose to apply this section and § 1.904(b)–2 to taxable years ending after July 20, 2004.

[T.D. 9141, 69 FR 43308, July 20, 2004; 69 FR 61761, Oct. 21, 2004]

§ 1.904(b)–2 Special rules for application of section 904(b) to alternative minimum tax foreign tax credit.

(a) *Application of section 904(b)(2)(B) adjustments*. Section 904(b)(2)(B) shall apply for purposes of determining the alternative minimum tax foreign tax credit under section 59 (regardless of whether or not the taxpayer has made an election under section 59(a)(4)).

(b) *Use of alternative minimum tax rates*—(1) *Taxpayers other than corporations*. In the case of a taxpayer other than a corporation, for purposes of determining the alternative minimum tax foreign tax credit under section 59—

(i) Section 904(b)(3)(D)(i) shall be applied by using the language ''section 55(b)(3)'' instead of ''subsection (h) of section 1'';

(ii) Section 904(b)(3)(E)(ii)(I) shall be applied by using the language ''section 55(b)(1)(A)(i)'' instead of ''subsection (a), (b), (c), (d), or (e) of section 1 (whichever applies)''; and

(iii) Section 904(b)(3)(E)(iii)(I) shall be applied by using the language ''the alternative rate of tax determined under section 55(b)(3)'' instead of ''the alternative rate of tax determined under section 1(h)''.

(2) *Corporate taxpayers*. In the case of a corporation, for purposes of determining the alternative minimum tax foreign tax credit under section 59, section 904(b)(3)(E)(ii)(II) shall be applied by using the language ''section 55(b)(1)(B)'' instead of ''section 11(b)''.

(c) *Effective date*. This section shall apply to taxable years beginning after July 20, 2004. See § 1.904(b)–1(i) for a rule permitting taxpayers to choose to apply § 1.904(b)–1 and this § 1.904(b)–2 to taxable years ending after July 20, 2004.

[T.D. 9141, 69 FR 43316, July 20, 2004; 69 FR 61761, Oct. 21, 2004]

§ 1.904(f)–0 Outline of regulation provisions.

This section lists the headings for §§ 1.904(f)–1 through 1.904(f)–8 and 1.904(f)–12.

§ 1.904(f)–0 Outline of regulation provisions.

This section lists the headings for §§ 1.904(f)–1 through 1.904(f)–8 and 1.904(f)–12.

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

(a)(1) Overview of regulations.

(2) Application to post-1986 taxable years.

(b) Overall foreign loss accounts.

(c) Determination of a taxpayer's overall foreign loss.

(1) Overall foreign loss defined.

(2) Separate limitation defined.

(3) Method of allocation and apportionment of deductions.

(d) Additions to the overall foreign loss account.

(1) General rule.

(2) Overall foreign losses of another taxpayer.

(3) Additions to overall foreign loss account created by loss carryovers.
(4) Adjustments for capital gains and losses.
(e) Reductions of overall foreign loss accounts.
(1) Pre-recapture reduction for amounts allocated to other taxpayers.
(2) Reduction for amounts recaptured.
(f) Illustrations.
(g) Effective/applicability date.

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

(a) In general.
(b) Determination of taxable income from sources without the United States for purposes of recapture.
(1) In general.
(c) Section 904(f)(1) recapture.
(1) In general.
(2) Election to recapture more of the overall foreign loss than is required under paragraph (c)(1).
(3) Special rule for recapture of losses incurred prior to section 936 election.
(4) Recapture of pre-1983 overall foreign losses determined on a combined basis.
(5) Illustrations.
(d) Recapture of overall foreign losses from dispositions under section 904(f)(3).
(1) In general.
(2) Treatment of net capital gain.
(3) Dispositions where gain is recognized irrespective of section 904(f)(3).
(i) Foreign source gain.
(ii) U.S. source gain.
(4) Dispositions in which gain would not otherwise be recognized.
(i) Recognition of gain to the extent of the overall foreign loss account.
(ii) Basis adjustment.
(iii) Recapture of overall foreign loss to the extent of amount recognized.
(iv) Priorities among dispositions in which gain is deemed to be recognized.
(5) Definitions.
(i) Disposition.
(ii) Property used in a trade or business.
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(iv) Property which is a material factor in the realization of income.
(6) Carryover of overall foreign loss accounts in a corporate acquisition to which section 381(a) applies.
(7) Illustrations.
(e) Effective/applicability.

§ 1.904(f)–4 Recapture of foreign losses out of accumulation distributions from a foreign trust.

(a) In general.
(b) Effect of recapture on foreign tax credit limitation under section 667(d).
(c) Recapture if taxpayer deducts foreign taxes deemed distributed.
(d) Illustrations.

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

(a) In general.
(b) Recapture of trust's overall foreign loss.
(1) Trust accumulates income.
(2) Trust distributes income.
(3) Trust accumulates and distributes income.
(c) Amounts allocated to beneficiaries.
(d) Section 904(f)(3) dispositions to which § 1.904(f)–2(d)(4)(i) is applicable.
(e) Illustrations.

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

(a) General Rule.
(b) Recapture of pre-1983 FORI and general limitation overall foreign losses from post-1982 income.
(1) Recapture from income subject to the same limitation.
(2) Recapture from income subject to the other limitation.
(c) Coordination of recapture of pre-1983 and post-1982 overall foreign losses.
(d) Illustrations.

§ 1.904(f)–7 Separate limitation loss and the separate limitation loss account.

(a) Overview of regulations.
(b) Definitions.
(1) Separate category.
(2) Separate limitation income.
(3) Separate limitation loss.
(c) Separate limitation loss account.
(d) Additions to separate limitation loss accounts.
(1) General rule.
(2) Separate limitation losses of another taxpayer.
(3) Additions to separate limitation loss account created by loss carryovers.
(e) Reductions of separate limitation loss accounts.
(1) Pre-recapture reduction for amounts allocated to other taxpayers.
(2) Reduction for offsetting loss accounts.
(3) Reduction for amounts recaptured.
(f) Effective/applicability date.

§ 1.904(f)–8 Recapture of separate limitation loss accounts.

(a) In general.
(b) Effect of recharacterization of separate limitation income on associated taxes.
(c) Effective/applicability date.

§ 1.904(f)–12 Transition rules.

(a) Recapture in years beginning after December 31, 1986, of overall foreign losses incurred in taxable years beginning before January 1, 1987.

(1) In general.

(2) Rule for general limitation losses.

(i) In general.

(ii) Exception.

(3) Priority of recapture of overall foreign losses incurred in pre-effective date taxable years.

(4) Examples.

(b) Treatment of overall foreign losses that are part of net operating losses incurred in pre-effective date taxable years which are carried forward to post-effective date taxable years.

(1) Rule.

(2) Example.

(c) Treatment of overall foreign losses that are part of net operating losses incurred in post-effective date taxable years which are carried back to pre-effective date taxable years.

(1) Allocation to analogous income category.

(2) Allocation to U.S. source income.

(3) Allocation to other separate limitation categories.

(4) Examples.

(d) Recapture of FORI and general limitation overall foreign losses incurred in taxable years beginning before January 1, 1983.

(e) Recapture of pre-1983 overall foreign losses determined on a combined basis.

(f) Transition rules for taxable years beginning before December 31, 1990.

(g) Recapture in years beginning after December 31, 2002, of separate limitation losses and overall foreign losses incurred in years beginning before January 1, 2003, with respect to the separate category for dividends from a noncontrolled section 902 corporation.

(1) Recapture of separate limitation loss or overall foreign loss in a separate category for dividends from a noncontrolled section 902 corporation.

(2) Recapture of separate limitation loss in another separate category.

(3) Exception.

(4) Examples.

(5) Effective/applicability date.

(h) Recapture in years beginning after December 31, 2006, of separate limitation losses and overall foreign losses incurred in years beginning before January 1, 2007.

(1) Losses related to pre-2007 separate categories for passive income, certain dividends from a DISC or former DISC, taxable income attributable to certain foreign trade income or certain distributions from a FSC or former FSC.

(i) Recapture of separate limitation loss or overall foreign loss incurred in a pre-2007 separate category for passive income, certain dividends from a DISC or former DISC, taxable income attributable to certain foreign trade income or certain distributions from a FSC or former FSC.

(ii) Recapture of separate limitation loss with respect to a pre-2007 separate category for passive income, certain dividends from a DISC or former DISC, taxable income attributable to certain foreign trade income or certain distributions from a FSC or former FSC.

(2) Losses related to pre-2007 separate categories for shipping, financial services income or general limitation income.

(i) Recapture of separate limitation loss or overall foreign loss incurred in a pre-2007 separate category for shipping income, financial services income or general limitation income.

(ii) Recapture of separate limitation loss with respect to a pre-2007 separate category for shipping income, financial services income or general limitation income.

(3) Losses related to a pre-2007 separate category for high withholding tax interest.

(i) Recapture of separate limitation loss or overall foreign loss incurred in a pre-2007 separate category for high withholding tax interest.

(ii) Recapture of separate limitation loss with respect to a pre-2007 separate category for high withholding tax interest.

(4) Elimination of certain separate limitation loss accounts.

(5) Alternative method.

(6) Effective/applicability date.

[T.D. 9371, 72 FR 72596, Dec. 21, 2007; T.D. 9452, 74 FR 27886, June 11, 2009, T.D. 9521, 76 FR 19273, Apr. 7, 2011; T.D. 9595, 77 FR 37578, June 22, 2012]

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

(a)(1) *Overview of regulations.* In general, section 904(f) and these regulations apply to any taxpayer that sustains an overall foreign loss (as defined in paragraph (c)(1) of this section) in a taxable year beginning after December 31, 1975. For taxable years ending after December 31, 1984, and beginning before January 1, 1987, there can be five types of overall foreign losses: a loss under each of the five separate limitations contained in former section 904(d)(1)(A) (passive interest limitation), (d)(1)(B) (DISC dividend limitation), (d)(1)(C) (foreign trade income limitation), (d)(1)(D) (foreign sales corporation (FSC) distributions limitation), and (d)(1)(E) (general limitation). For taxable years beginning after December 31, 1982, and ending before January 1, 1985,

there can be three types of overall foreign losses under former section 904(d)(1)(A) (passive interest limitation), former section 904(d)(1)(B) (DISC dividend limitation) and former section 904(d)(1)(C) (general limitation). For taxpayers subject to section 907, the post-1982 general limitation overall foreign loss account may be further subdivided, as provided in §1.904(f)–6. For taxable years beginning after December 31, 1975, and before January 1, 1983, taxpayers should have computed overall foreign losses separately under the passive interest limitation, the DISC dividend limitation, the general limitation, and the section 907(b) (FORI) limitation. However, for taxable years beginning after December 31, 1975, and before January 1, 1983, taxpayers may have computed only two types of overall foreign losses: A foreign oil related loss under the FORI limitation and an overall foreign loss computed on a combined basis for the passive interest limitation, the DISC dividend limitation, and the general limitation. A taxpayer that computed overall foreign losses for these years on a combined basis will not be required to amend its return to recompute such losses on a separate basis. If a taxpayer computed its overall foreign losses for these years separately under the passive interest limitation, the DISC dividend limitation, and the general limitation, on returns previously filed, a taxpayer may not amend those returns to compute such overall foreign losses on a combined basis. Section 1.904(f)–1 provides rules for determining a taxpayer's overall foreign losses, for establishing overall foreign loss accounts, and for making additions to and reductions of such accounts for purposes of section 904(f). Section 1.904(f)–2 provides rules for recapturing the balance in any overall foreign loss account under the general recapture rule of section 904(f)(1) and under the special recapture rule of section 904(f)(3) when the taxpayer disposes of property used predominantly outside the United States in a trade or business. Section 1.904(f)–3 provides rules for allocating overall foreign losses that are part of net operating losses or net capital losses to foreign source income in years to which such losses are carried. In addition, §1.904(f)–3 provides transition rules for the treatment of net operating losses incurred in taxable years beginning after December 31, 1982, and carried back to taxable years beginning before January 1, 1983, and of net operating losses incurred in taxable years beginning before January 1, 1983, and carried forward to taxable years beginning after December 31, 1982. Section 1.904(f)–4 provides rules for recapture out of an accumulation distribution of a foreign trust. Section 1.904(f)–5 provides rules for recapture of overall foreign losses of domestic trusts. Section 1.904(f)–6 provides a transition rule for recapturing a taxpayer's pre-1983 overall foreign losses under the general limitation and the FORI limitation out of taxable income subject to the general limitation in taxable years beginning after December 31, 1982. Section §1.1502–9 provides rules concerning the application of these regulations to corporations filing consolidated returns.

(2) *Application to post-1986 taxable years.* The principles of §§1.904(f)–1 through 1.904(f)–5 shall apply to any overall foreign loss sustained in taxable years beginning after December 31, 1986, modified so as to take into account the effect of statutory amendments.

(b) *Overall foreign loss accounts.* Any taxpayer that sustains an overall foreign loss under paragraph (c) of this section must establish an account for such loss. Separate types of overall foreign losses must be kept in separate accounts. For taxable years beginning prior to January 1, 1983, taxpayers that computed losses on a combined basis in accordance with §1.904(f)–1(c)(1) will keep one overall foreign loss account for such overall foreign loss. The balance in each overall foreign loss account represents the amount of such overall foreign loss subject to recapture by the taxpayer in a given year. From year to year, amounts may be added to or subtracted from the balances in such accounts as provided in paragraphs (d) and (e) of this section. The taxpayer must report the balances (if any) in its overall foreign loss accounts annually on a Form 1116 or 1118. Such forms must be filed for each taxable year ending after September 24, 1987. The balance in each account does

not have to be attributed to the year or years in which the loss was incurred.

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

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

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

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

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

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

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

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

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

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

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

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

(4) *Adjustments for capital gains and losses and qualified dividend income.* If a taxpayer has capital gains or losses or qualified dividend income, as defined in section 1(h)(11), the taxpayer shall make adjustments to such capital gains and losses and qualified dividend income to the extent required under section 904(b)(2) and § 1.904(b)–1 before applying the provisions of § 1.904(f)–1. See § 1.904(b)–1(h).

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

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

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

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

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

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

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

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

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

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

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

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

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

to that loss will be added to the overall foreign loss account in 1985 or in any other year.

(g) *Effective/applicability date.* Paragraphs (a)(2) and (d)(4) of this section shall apply to taxable years beginning on or after January 1, 2012. Taxpayers may choose to apply paragraphs (a)(2) and (d)(4) of this section to other taxable years beginning after December 21, 2007, including periods covered by 26 CFR 1.904(f)–1T (revised as of April 1, 2010).

[T.D. 8153, 52 FR 31994, Aug. 25, 1987; 52 FR 43434, Nov. 12, 1987, as amended by T.D. 9371, 72 FR 72597, Dec. 21, 2007; T.D. 9595, 77 FR 37578, June 22, 2012]

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

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

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

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

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

(c) *Section 904(f)(1) recapture*—(1) *In general.* In a taxable year in which a taxpayer elects the benefits of section 901 or section 30A, the section 904(f)(1) recapture amount is the amount of foreign source taxable income subject to recharacterization in a taxable year in which recapture of an overall foreign loss is required under paragraph (a) of this section. The section 904(f)(1) recapture amount equals the lesser of the aggregate amount of maximum potential recapture in all overall foreign loss accounts or fifty percent of the taxpayer's total foreign source taxable income. If the aggregate amount of maximum potential recapture in all overall foreign loss accounts exceeds fifty percent of the taxpayer's total foreign source taxable income, foreign source taxable income in each separate category with an overall foreign loss account is recharacterized in an amount equal to the section 904(f)(1) recapture amount, multiplied by the maximum

potential recapture in the overall foreign loss account, divided by the aggregate amount of maximum potential recapture in all overall foreign loss accounts. The maximum potential recapture in an overall foreign loss account in a separate category is the lesser of the balance in that overall foreign loss account or the foreign source taxable income for the year in the same separate category as the loss account. If, in any taxable year, in accordance with sections 164(a) and 275(a)(4)(A), a taxpayer deducts rather than credits its foreign taxes, recapture is applied to the extent of the lesser of—

(i) The balance in the overall foreign loss account in each separate category; or

(ii) Foreign source taxable income (net of foreign taxes) in each separate category.

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

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

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

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

Example 1. X Corporation is a domestic corporation that does business in the United States and abroad. On December 31, 1983, the balance in X's general limitation overall foreign loss account is $600, all of which is attributable to a loss incurred in 1983. For 1984, X has United States source taxable income of $500 and foreign source taxable income subject to the general limitation of $500. For 1984, X pays $200 in foreign taxes and elects

section 901. Under paragraph (c)(1) of this section, X is required to recapture $250 (the lesser of $600 or 50 percent of $500) of its overall foreign loss. As a consequence, X's foreign tax credit limitation under the general limitation is $250/$1,000 × $500, or $125, instead of $500/$1,000 × $500, or $250. The balance in X's general limitation overall foreign loss account is reduced by $250 in accordance with § 1.904(f)–1(e)(2).

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

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

Example 4. Y Corporation is a domestic corporation that does business in the United States and abroad. On December 31, 2007, the balance in Y's general category overall foreign loss account is $500, all of which is attributable to a loss incurred in 2007. Y has no other loss accounts subject to recapture. For 2008, Y has U.S. source taxable income of $400 and foreign source taxable income of $300 in the general category and $900 in the passive category. Under paragraph (c)(1) of this section, the amount of Y's general category income subject to recharacterization is the lesser of the aggregate maximum potential recapture or 50% of the total foreign source taxable income. In this case, Y's aggregate maximum potential recapture is $300 (the lesser of the $500 balance in the general category overall foreign loss account or $300 foreign source income in the general category for the year), which is less than 50% of Y's total foreign source taxable income ($1200 × 50% = $600). Therefore, pursuant to paragraph (c) of this section, $300 of foreign source income in the general category is recharacterized as U.S. source income. The balance in Y's general category overall foreign loss account is reduced to $200 in accordance with § 1.904(f)–1(e)(2).

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

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

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

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

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

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

(d) *Recapture of overall foreign losses from dispositions under section 904(f)(3)*—(1) *In general.* If a taxpayer disposes of property used or held for use predominantly without the United States in a trade or business during a taxable year

and that property generates foreign source taxable income subject to a separate limitation to which paragraph (a) of this section applies, the applicable overall foreign loss account shall be recaptured as provided in paragraphs (d)(2), (d)(3), and (d)(4) of this section. See paragraph (d)(5) of this section for definitions. See the ordering rules under § 1.904(g)–3(f) and (i) for coordination with other loss recapture under section 904(f) and (g).

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

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

(ii) *U.S. source gain.* If a taxpayer recognizes U.S. source gain on the disposition of property described in paragraph (d)(1) of this section, and there is a balance in a taxpayer's overall foreign loss account that is attributable to a loss in the separate category to which the income generated by such property is assigned after applying paragraph (c) of this section, an amount of the gain shall be treated as foreign source and an additional portion of such balance equal to that amount shall be recaptured in accordance with paragraphs (a) and (b) of this section. The amount of gain treated as foreign source and the amount of overall foreign loss recaptured shall be the lesser of the balance in the overall foreign loss account or the full amount of the gain recognized on the disposition.

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

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

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

The excess of the fair market value of such property over its adjusted basis shall be determined on an asset by asset basis. Losses from the disposition of an asset shall not be recognized. Any foreign source taxable income deemed received and recognized under this paragraph (d)(4)(i) will have the same character as if the property had been sold or exchanged in a taxable transaction and will constitute gain for all purposes.

(ii) *Basis adjustment.* The basis of the property received in an exchange to which this paragraph (d)(4) applies shall be increased by the amount of gain deemed recognized, in accordance

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

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

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

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

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

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

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

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

(ii) *Property used in a trade or business.* Property is used in a trade or business if it is held for the principal purpose of promoting the present or future conduct of the trade or business. This generally includes property acquired and held in the ordinary course of a trade or business or otherwise held in a direct relationship to a trade or business. In determining whether an asset is held in a direct relationship to a trade or business, principal consideration shall be given to whether the asset is used in the trade or business. Property will be treated as held in a direct relationship to a trade or business if the property was acquired with funds generated by that trade or business or if income generated from the asset is available for use in that trade or business. Property used in a trade or business may be tangible or intangible, real

or personal property. It includes property, such as equipment, which is subject to an allowance for depreciation under section 167 or cost recovery under section 168. Property may be considered used in a trade or business even if it is a capital asset in the hands of the taxpayer. However, stock of another corporation shall not be considered property used in a trade or business if a substantial investment motive exists for acquiring and holding the stock. On the other hand, stock acquired or held to assure a source of supply for a trade or business shall be considered property used in that trade or business. Inventory is generally not considered property used in a trade or business. However, when disposed of in a manner not in the ordinary course of a trade or business, inventory will be considered property used in the trade or business. A partnership interest will be treated as property used in a trade or business if the underlying assets of the partnership would be property used in a trade or business. For purposes of section 904(f) (3) and § 1.904(f)–2 (d) (1) and (5), a disposition of a partnership interest to which this section applies will be treated as a disposition of a proportionate share of each of the assets of the partnership. For purposes of allocating the purchase price of the interest and the seller's basis in the interest to those assets, the principles of § 1.751–1(a) will apply.

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

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

(6) *Carryover of overall foreign loss accounts in a corporate acquisition to which section 381(a) applies.* In the case of a distribution or transfer described in section 381(a), an overall foreign loss account of the distributing or transferor corporation shall be treated as an overall foreign loss account of the acquiring or transferee corporation as of the close of the date of the distribution or transfer. If the transferee corporation had an overall foreign loss account under the same separate limitation prior to the distribution or transfer, the balance in the transferor's account must be added to the transferee's account. If not, the transferee must adopt the transferor's overall foreign loss account. An overall foreign loss of the transferor will be treated as incurred by the transferee in the year prior to the year of the transfer.

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

Example 1. X Corporation has a balance in its general limitation overall foreign loss account of $600 at the close of its taxable year ending December 31, 1984. In 1985, X sells assets used predominantly outside the United States in a trade or business and recognizes $1,000 of gain on the sale under section 1001. This gain is subject to the general limitation. This sale is a disposition within the meaning of paragraph (d)(5)(i) of this section, and to which this paragraph (d) applies. X has no other foreign source taxable income in 1985 and has $1,000 of United States source taxable income. Under paragraph (c), X is required to recapture $500 (the lesser of the balance in X's general limitation overall foreign loss account ($600) or 50 percent of $1,000) of its overall foreign loss account. The

balance in X's general limitation overall foreign loss account is reduced to $100 in accordance with §1.904(f)–1(e)(2). In addition, under paragraph (d)(3) of this section, X is required to recapture $100 (the lesser of the remaining balance in its general limitation overall foreign loss account ($100) or 100 percent of its foreign source taxable income recognized on such disposition that has not been previously recharacterized ($500)). The total amount recaptured is $600. X's foreign tax credit limitation for income subject to the general limitation in 1985 is $200 ($400/$2,000 × $1,000) instead of $500 ($1,000/$2,000 × $1,000). The balance in X's general limitation overall foreign loss account is reduced to zero in accordance with §1.904(f)–1(e)(2).

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

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

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

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

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

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

Example 4. Z Corporation has a balance in its FORI overall foreign loss account of $1,500 at the end of its taxable year 1980. In

1981, Z has $1,600 of foreign oil related income subject to the separate limitation for FORI income and no United States source income. In addition, in 1981, Z makes two dispositions of property used predominantly outside the United States in a trade or business on which no gain was recognized. Such property generated foreign oil related income. The excess of the fair market value of the property transferred in the first disposition over Z's adjusted basis in such property is $575. The excess of the fair market value of the property transferred in the second disposition over Z's adjusted basis in such property is $1,000. Under paragraph (c) of this section, Z is required to recapture $800 (the lesser of 50 percent of its foreign oil related income of $1,600 or the balance ($1,500) in its FORI overall foreign loss account) of its foreign oil related loss. In accordance with paragraphs (d)(4) (i) and (iv) of this section, Z is required to recognize foreign oil related income in the amount of $575 on the first disposition and, since the foreign oil related loss account is now reduced by $1,375 (the $800 and $575 amounts previously recaptured), Z is required to recognize foreign oil related income in the amount of $125 on the second disposition. In accordance with paragraph (d)(4)(iii) of this section, the entire amount recognized is treated as United States source income and the balance in the FORI overall foreign loss account is reduced to zero under § 1.904 (f)–1 (e)(2). Z's foreign tax credit limitation for FORI is $400 ($800/$2,300 × $1,150) instead of $800 ($1,600/$1,600 × $800).

Example 5. The facts are the same as in example 4, except that the gain from the two dispositions of property is treated as net capital gain and the United States corporate tax rate is assumed to be 46 percent. As in example 4, Z is required to recapture $800 of its foreign oil related loss from its 1981 ordinary foreign oil related income. In accordance with paragraph (d)(4) (i) and (iv) of this section, Z is first required to recognize foreign oil related income (which is net capital gain) on the first disposition in the amount of $575. Under paragraphs (b) and (d) (2) of this section, this net capital gain is adjusted by subtracting the rate differential portion of such gain from the total amount of such gain to determine the amount by which the foreign oil related loss account is reduced, which is $350 ($575 − ($575 × 18/46)). The balance remaining in Z's foreign oil related loss account after this step is $350. Therefore, this process will be repeated, in accordance with paragraph (d)(4)(iv) of this section, to recapture that remaining balance out of the gain deemed recognized on the second disposition, resulting in reduction of the foreign oil related loss account to zero and net capital gain required to be recognized from the second dispostion in the amount of $575, which must also be adjusted by subtracting the rate differential portion to determine the amount by which the foreign oil related loss account is reduced (which is $350). The $575 of net capital gain from each disposition is recharacterized as United States source net capital gain. Z's section 907 (b) foreign tax credit limitation is the same as in example 4, and Z has $1,150 ($575 + $575) of United States source net capital gain.

(e) *Effective/applicability date.* Paragraphs (c)(1), (c)(5) *Example 4*, (d)(1), and (d)(3) of this section shall apply to taxable years beginning on or after January 1, 2012. Taxpayers may choose to apply paragraphs (c)(1), (c)(5) *Example 4*, (d)(1), and (d)(3) of this section to other taxable years beginning after December 21, 2007, including periods covered by 26 CFR 1.904(f)–2T (revised as of April 1, 2010).

[T.D. 8153, 52 FR 31997, Aug. 25, 1987; 52 FR 43434, Nov. 12, 1987, as amended by T.D. 9371, 72 FR 72597, Dec. 21, 2007; T.D. 9595, 77 FR 37578, June 22, 2012]

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

For rules relating to the allocation of net operating losses and net capital losses, see § 1.904(g)–3T.

[T.D. 9371, 72 FR 72598, Dec. 21, 2007]

§ 1.904(f)–4 Recapture of foreign losses out of accumulation distributions from a foreign trust.

(a) *In general.* If a taxpayer receives a distribution of foreign source taxable income subject to a separate limitation in which the taxpayer had a balance in an overall foreign loss account and that income is treated under section 666 as having been distributed by a foreign trust in a preceding taxable year, a portion of the balance in the taxpayer's applicable overall foreign loss account shall be subject to recapture under this section. The amount subject to recapture shall be the lesser of the balance in the taxpayer's overall foreign loss account (after applying §§ 1.904(f)–1, 1.904(f)–2, 1.904(f)–3, and 1.904(f)–6 to the taxpayer's other income or loss in the current taxable year) or the entire amount of foreign source taxable income deemed distributed in a preceding year or years under section 666.

(b) *Effect of recapture on foreign tax credit limitation under section 667(d).* If

paragraph (a) of this section is applicable, then in applying the separate limitation (in accordance with section 667(d)(1) (A) and (C)) to determine the amount of foreign taxes deemed distributed under section 666 (b) and (c) that can be credited against the increase in tax in a computation year, a portion of the foreign source taxable income deemed distributed in such computation year shall be treated as United States source income. Such portion shall be determined by multiplying the amount of foreign source taxable income deemed distributed in the computation year by a fraction. The numerator of this fraction is the balance in the taxpayer's overall foreign loss account (after application of §§ 1.904(f)–1, 1.904(f)–2, 1.904(f)–3, and 1.904(f)–6), and the denominator of the fraction is the entire amount of foreign source taxable income deemed distributed under section 666. However, the numerator of this fraction shall not exceed the denominator of the fraction.

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

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

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

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

[T.D. 8153, 52 FR 32002, Aug. 25, 1987]

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

(a) *In general.* Except as provided in this section, the rules contained in §§ 1.904(f)–1, 1.904(f)–2, 1.904(f)–3, 1.904(f)–4, and 1.904(f)–6 apply to domestic trusts.

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

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

(2) *Trust distributes income.* If the trust distributes all of its foreign source taxable income subject to the same limitation as the loss that created the overall foreign loss account, the amount of the overall foreign loss that would be subject to recapture by the trust under paragraph (b)(1) of this

section shall be allocated to the beneficiaries in proportion to the amount of such income which is distributed to each beneficiary in that year.

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

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

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

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

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

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

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

$500. Under § 1.904(f)-1(e)(2), T reduces its general limitation overall foreign loss account by $250. At the end of 1985 there is a balance in the general limitation overall foreign loss account of $450 (($1,200 – $500) – $250).

[T.D. 8153, 52 FR 32002, Aug. 25, 1987; 52 FR 43434, Nov. 12, 1987]

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

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

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

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

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

(1) *Recapture from income subject to the same limitation*. The taxpayer shall first apply the rules of §§ 1.904(f)–1 through 1.904(f)–5 to the taxpayer's separately determined foreign oil related income to recapture the pre-1983 FORI limitation overall foreign loss account, and shall apply such rules to the taxpayer's separately determined general limitation income (exclusive of foreign oil related income) to recapture the pre-1983 general limitation overall foreign loss account (or the section 904(d)(1)(A-C) overall foreign loss account. Rules for determining the recapture of the pre-1983 section 904 (d)(1)(A-C) losses are contained in § 1.904(f)–2(c)(4).

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

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

(ii) The amount recaptured from such separately determined income under

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

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

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

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

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

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

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

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

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

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

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

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

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

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

The amount recaptured from foreign oil related income is the lesser of $750 (the remaining pre-1983 section 904(d)(1)(A-C) overall foreign loss account) or 50 percent of $600 (the separately determined foreign oil related income), but as limited by paragraph

(b)(2)(ii) of this section to (12½ percent of $1,000 × 3)–($125 + $25), which is $225. ($125 is the amount recaptured in 1983 under paragraph (b)(2) of this section, and $25 is the amount recaptured in 1984 under paragraph (b)(2) of this section.)

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

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

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

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

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

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

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

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

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

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

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

Amount recaptured under paragraph (b)(2) of this section $100

The amount of pre-1983 FORI 907(b) overall foreign loss recaptured from section general limitation income exclusive of foreign oil related income is the lesser of $500 (the remaining balance in that loss account) or 50 percent of $1,000 (the general limitation income exclusive of foreign oil related income), but only to the extent that the amount recaptured from such income under paragraph (b)(1) of this section is less than 50 percent of such income, or $100 (50 percent of $1,000)—$400 recaptured due to section 904(d)(1)(A-C) overall foreign loss account, and only up to the amount permitted by paragraph (b)(2)(ii) of this section, which is (12½ percent of $1,000 × 1) − $0, or $125.

Total amount recaptured in 1983 ..... $1,000

At the end of 1983, Z has reduced its pre-1983 section 904(d)(1)(A-C) overall foreign loss account to zero, and has a balance in its pre-1983 FORI overall foreign loss account of $400.

[T.D. 8153, 52 FR 32003, Aug. 25, 1987; 52 FR 43434, Nov. 12, 1987]

§ 1.904(f)–7 Separate limitation loss and the separate limitation loss account.

(a) *Overview of regulations.* This section provides rules for determining a taxpayer's separate limitation losses, for establishing separate limitation loss accounts, and for making additions to and reducing such accounts for purposes of section 904(f). Section 1.904(f)–8 provides rules for recharacterizing the balance in any separate limitation loss account under the general recharacterization rule of section 904(f)(5)(C).

(b) *Definitions.* The definitions in paragraphs (b)(1) through (b)(4) of this section apply for purposes of this section and §§ 1.904(f)–8 and 1.904(g)–3.

(1) *Separate category* means each separate category of income described in

section 904(d) and any other category of income described in § 1.904–4(m). For example, income subject to section 901(j) or section 904(h)(10) is income in a separate category.

(2) *Separate limitation income* means, with respect to any separate category, the taxable income from sources outside the United States, separately computed for that category for the taxable year. Separate limitation income shall be determined by taking into account any adjustments for capital gains and losses and qualified dividend income, as defined in section 1(h)(11), under section 904(b)(2) and § 1.904(b)–1. See § 1.904(b)–1(h)(1)(i).

(3) *Separate limitation loss* means, with respect to any separate category, the amount by which the foreign source gross income in that category is exceeded by the sum of expenses, losses and other deductions (not including any net operating loss deduction under section 172(a) or any expropriation loss or casualty loss described in section 907(c)(4)(D)(iii)) properly apportioned or allocated to that separate category for the taxable year. Separate limitation losses shall be determined by taking into account any adjustments for capital gains and losses and qualified dividend income under section 904(b)(2) and § 1.904(b)–1. See § 1.904(b)–1(h)(1)(i).

(c) *Separate limitation loss account*. Any taxpayer that sustains a separate limitation loss that is allocated to reduce separate limitation income in one or more other separate categories of the taxpayer under the rules of § 1.904(g)–3 must establish a separate limitation loss account for the loss with respect to each such other separate category. The balance in any separate limitation loss account represents the amount of such separate limitation loss that is subject to recapture in a given taxable year pursuant to § 1.904(f)–8 and section 904(f)(5)(F). From year to year, amounts may be added to or subtracted from the balance in such loss accounts, as provided in paragraphs (d) and (e) of this section.

(d) *Additions to separate limitation loss accounts*—(1) *General rule*. A taxpayer's separate limitation loss as defined in paragraph (b)(3) of this section shall be added to the applicable separate limitation loss accounts at the end of its taxable year to the extent that the separate limitation loss reduces separate limitation income in one or more other separate categories in that taxable year or in a year to which the loss has been carried back. For rules with respect to net operating loss carryovers, see paragraph (d)(3) of this section and § 1.904(g)–3.

(2) *Separate limitation losses of another taxpayer*. If any portion of any separate limitation loss account of another taxpayer is allocated to the taxpayer in accordance with § 1.1502–9 (relating to consolidated separate limitation losses) the taxpayer shall add such amount to its applicable separate limitation loss account.

(3) *Additions to separate limitation loss account created by loss carryovers*. The taxpayer shall add to each separate limitation loss account all net operating loss carryovers to the current taxable year to the extent that separate limitation losses included in the net operating loss carryovers reduced foreign source income in one or more other separate categories for the taxable year.

(e) *Reductions of separate limitation loss accounts*. The taxpayer shall subtract the following amounts from its separate limitation loss accounts at the end of its taxable year in the following order as applicable:

(1) *Pre-recapture reduction for amounts allocated to other taxpayers*. A separate limitation loss account is reduced by the amount of any separate limitation loss account that is allocated to another taxpayer in accordance with § 1.1502–9 (relating to consolidated separate limitation losses).

(2) *Reduction for offsetting loss accounts*. A separate limitation loss account is reduced to take into account any netting of separate limitation loss accounts under § 1.904(g)–3(d)(1).

(3) *Reduction for amounts recaptured*. A separate limitation loss account is reduced by the amount of any separate limitation income that is earned in the same separate category as the separate

limitation loss and that is recharacterized in accordance with §1.904(f)–8 (relating to recapture of separate limitation losses) or section 904(f)(5)(F) (relating to recapture of separate limitation loss accounts out of gain realized from certain dispositions).

(f) *Effective/applicability date.* This section applies to taxpayers that sustain separate limitation losses in taxable years beginning on or after January 1, 2012. Taxpayers may choose to apply this section to separate limitation losses sustained in other taxable years beginning after December 21, 2007, including periods covered by 26 CFR 1.904(f)–7T (revised as of April 1, 2010). For rules relating to taxable years beginning after December 31, 1986, and on or before December 21, 2007, see section 904(f)(5).

[T.D. 9595, 77 FR 37579, June 22, 2012]

§ 1.904(f)–8 Recapture of separate limitation loss accounts.

(a) *In general.* A taxpayer shall recapture a separate limitation loss account as provided in this section. If the taxpayer has a separate limitation loss account or accounts in any separate category (the ''loss category'') and the loss category has income in a subsequent taxable year, the income shall be recharacterized as income in that other category or categories. The amount of income recharacterized shall not exceed the aggregate balance in all separate limitation loss accounts for the loss category as determined under §1.904(f)–7. If the taxpayer has more than one separate limitation loss account in a loss category, and there is not enough income in the loss category to recapture all of the loss accounts, then separate limitation income in the loss category shall be recharacterized as separate limitation income in the other separate categories on a proportionate basis. This is determined by multiplying the total separate limitation income subject to recharacterization by a fraction, the numerator of which is the amount in a particular separate limitation loss account and the denominator of which is the total amount in all separate limitation loss accounts for the loss category.

(b) *Effect of recharacterization of separate limitation income on associated taxes.* Recharacterization of income under paragraph (a) of this section shall not result in the recharacterization of any tax. The rules of §1.904–6, including the rules that the taxes are allocated on an annual basis and that foreign taxes paid on U.S. source income shall be allocated to the separate category that includes that U.S. source income (see §1.904–6(a)), shall apply for purposes of allocating taxes to separate categories. Allocation of taxes pursuant to §1.904–6 shall be made before the recapture of any separate limitation loss accounts of the taxpayer pursuant to the rules of this section.

(c) *Effective/applicability date.* This section applies to taxpayers that sustain separate limitation losses in taxable years beginning on or after January 1, 2012. Taxpayers may choose to apply this section to separate limitation losses sustained in other taxable years beginning after December 21, 2007, including periods covered by 26 CFR §1.904(f)–8T (revised as of April 1, 2010). For rules relating to taxable years beginning after December 31, 1986, and on or before December 21, 2007, see section 904(f)(5).

[T.D. 9595, 77 FR 37580, June 22, 2012]

§§ 1.904(f)–9—1.904(f)–11 [Reserved]

§ 1.904(f)–12 Transition rules.

(a) *Recapture in years beginning after December 31, 1986, of overall foreign losses incurred in taxable years beginning before January 1, 1987*—(1) *In general.* If a taxpayer has a balance in an overall foreign loss account at the end of its last taxable year beginning before January 1, 1987 (pre-effective date years), the amount of that balance shall be recaptured in subsequent years by recharacterizing income received in the income category described in section 904(d) as in effect for taxable years beginning after December 31, 1986 (post-effective date years), that is analogous to the income category for which the overall foreign loss account was established, as follows:

(i) Interest income as defined in section 904(d)(1)(A) as in effect for pre-effective date taxable years is analogous to passive income as defined in section 904(d)(1)(A) as in effect for post-effective date years;

(ii) Dividends from a DISC or former DISC as defined in section 904(d)(1)(B) as in effect for pre-effective date taxable years is analogous to dividends from a DISC or former DISC as defined in section 904(d)(1)(F) as in effect for post-effective date taxable years;

(iii) Taxable income attributable to foreign trade income as defined in section 904(d)(1)(C) as in effect for pre-effective date taxable years is analogous to taxable income attributable to foreign trade income as defined in section 904(d)(1)(G) as in effect for post-effective date years;

(iv) Distributions from a FSC (or former FSC) as defined in section 904(d)(1)(D) as in effect for pre-effective date taxable years is analogous to distributions from a FSC (or former FSC) as defined in section 904(d)(1)(H) as in effect for post-effective date taxable years;

(v) For general limitation income as described in section 904(d)(1)(E) as in effect for pre-effective date taxable years, see the special rule in paragraph (a)(2) of this section.

(2) *Rule for general limitation losses*—(i) *In general.* Overall foreign losses incurred in the general limitation category of section 904(d)(1)(E), as in effect for pre-effective date taxable years, that are recaptured in post-effective date taxable years shall be recaptured from the taxpayer's general limitation income, financial services income, shipping income, and dividends from each noncontrolled section 902 corporation. If the sum of the taxpayer's general limitation income, financial services income, shipping income and dividends from each noncontrolled section 902 corporation for a taxable year subject to recapture exceeds the overall foreign loss to be recaptured, then the amount of each type of separate limitation income that will be treated as U.S. source income shall be determined as follows:

$$\text{Overall foreign loss subject to recapture} \times \frac{\text{Amount of income in each separate category from which the loss may be recaptured}}{\text{Sum of income in all separate categories from which the loss may be recaptured.}}$$

This recapture shall be made after the allocation of separate limitation losses pursuant to section 904(f)(5)(B) and before the recharacterization of post-effective date separate limitation income pursuant to section 904(f)(5)(C).

(ii) *Exception.* If a taxpayer can demonstrate to the satisfaction of the district director that an overall foreign loss in the general limitation category of section 904(d)(1)(E), as in effect for pre-effective date taxable years, is attributable, in sums certain, to losses in one or more separate categories of section 904(d)(1) (including for this purpose the passive income category and the high withholding tax interest category), as in effect for post-effective date taxable years, then the taxpayer may recapture the loss (in the amounts demonstrated) from those separate categories only.

(3) *Priority of recapture of overall foreign losses incurred in pre-effective date taxable years.* An overall foreign loss incurred by a taxpayer in pre-effective date taxable years shall be recaptured to the extent thereof before the taxpayer recaptures an overall foreign loss incurred in a post-effective date taxable year.

(4) *Examples.* The following examples illustrate the application of this paragraph (a).

Example 1. X corporation is a domestic corporation which operates a branch in Country Y. For its taxable year ending December 31, 1988, X has $800 of financial services income, $100 of general limitation income and $100 of shipping income. X has a balance of $100 in its general limitation overall foreign loss account which resulted from an overall foreign loss incurred during its 1986 taxable year. X is unable to demonstrate to which of the income categories set forth in section 904(d)(1) as in effect for post-effective date taxable years the loss is attributable. In addition, X has a balance of $100 in its shipping overall

foreign loss account attributable to a shipping loss incurred during its 1987 taxable year. X has no other overall foreign loss accounts. Pursuant to section 904(f)(1), the full amount in each of X corporation's overall foreign loss accounts is subject to recapture since $200 (the sum of those amounts) is less than 50% of X's foreign source taxable income for its 1988 taxable year, or $500. X's overall foreign loss incurred during its 1986 taxable year is recaptured before the overall foreign loss incurred during its 1987 taxable year, as follows: $80 ($100 × 800/1000) of X's financial services income, $10 ($100 × 100/1000) of X's general limitation income, and $10 (100 × 100/1000) of X's shipping income will be treated as U.S. source income. The remaining $90 of X corporation's 1988 shipping income will be treated as U.S. source income for the purpose of recapturing X's 100 overall foreign loss attributable to the shipping loss incurred in 1987. $10 remains in X's shipping overall foreign loss account for recapture in subsequent taxable years.

Example 2. The facts are the same as in *Example* 1 except that X has $800 of financial services income, $100 of general limitation income, a $100 dividend from a noncontrolled section 902 corporation and a ($100) shipping loss for its taxable year ending December 31, 1988. Separate limitation losses are allocated pursuant to the rules of section 904(f)(5) before the recapture of overall foreign losses. Therefore, the ($100) shipping loss incurred by X will be allocated to its separate limitation income as follows: $80 ($100 × 800/1000) will be allocated to X's financial services income, $10 ($100 × 100/1000) will be allocated to its general limitation income and $10 ($100 × 100/1000) will be allocated to X's dividend from the noncontrolled section 902 corporation. Accordingly, after allocation of the 1988 shipping loss, X has $720 of financial services income, $90 of general limitation income, and a $90 dividend from the noncontrolled section 902 corporation. Pursuant to section 904(f)(1), the full amount in each of X corporation's overall foreign loss accounts is subject to recapture since $200 (the sum of those amounts) is less than 50% of X's net foreign source taxable income for its 1988 taxable year, or $450. X's overall foreign loss incurred during its 1986 taxable year is recaptured as follows: $80 ($100 × 720/900) of X's financial services income, $10 ($100 × 90/900) of its general limitation income and $10 ($100 × 90/900) of its dividend from the noncontrolled section 902 corporation will be treated as U.S. source income. Accordingly, after application of section 904(f), X has $100 of U.S. source income, $640 of financial services income, $80 of general limitation income and a $80 dividend from the noncontrolled section 902 corporation for its 1988 taxable year. X must establish a separate limitation loss account for each portion of the 1988 shipping loss that was allocated to its financial services income, general limitation income and dividends from the noncontrolled section 902 corporation. X's overall foreign loss account for the 1986 general limitation loss is reduced to zero. X still has a $100 balance in its overall foreign loss account that resulted from the 1987 shipping loss.

Example 3. Y is a domestic corporation which has a branch operation in Country Z. For its 1988 taxable year, Y has $5 of shipping income, $15 of general limitation income and $100 of financial services income. Y has a balance of $100 in its general limitation overall foreign loss account attributable to its 1986 taxable year. Y has no other overall foreign loss accounts. Pursuant to section 904(f)(1), $60 of the overall foreign loss is subject to recapture since 50% of Y's foreign source income for 1988 is less than the balance in its overall foreign loss account. Y can demonstrate that the entire $100 overall foreign loss was attributable to a shipping limitation loss incurred in 1986. Accordingly, only Y's $5 of shipping limitation income received in 1988 will be treated as U.S. source income, Because Y can demonstrate that the 1986 loss was entirely attributable to a shipping loss, none of Y's general limitation income or financial services income received in 1988 will be treated as U.S. source income.

Example 4. The facts are the same as in *Example* 3 except that Y can only demonstrate that $50 of the 1986 overall foreign loss account was attributable to a shipping loss incurred in 1986. Accordingly, Y's $5 of shipping limitation income received in 1988 will be treated as U.S. source income. The remaining $50 of the 1986 overall foreign loss that Y cannot trace to a particular separate limitation will be recaptured and treated as U.S. source income as follows: $43 ($50 × 100/115) of Y's financial services income will be treated as U.S. source income and $7 ($50 × 15/115) of Y's general limitation income will be treated as U.S. source income. Y has $45 remaining in its overall foreign loss account to be recaptured from shipping income in a future year.

(b) *Treatment of overall foreign losses that are part of net operating losses incurred in pre-effective date taxable years which are carried forward to post-effective date taxable years*—(1) *Rule.* An overall foreign loss that is part of a net operating loss incurred in a pre-effective date taxable year which is carried forward, pursuant to section 172, to a post-effective date taxable year will be carried forward under the rules of section 904(f)(5) and the regulations under that section. *See also* Notice 89–3, 1989–1 C.B. 623. For this purpose the loss

must be allocated to income in the category analogous to the income category set forth in section 904(d) as in effect for pre-effective date taxable years in which the loss occurred. The analogous category shall be determined under the rules of paragraph (a) of this section.

(2) *Example*. The following example illustrates the rule of paragraph (b)(1) of this section.

Example. Z is a domestic corporation which has a branch operation in Country D. For its taxable year ending December 31, 1988, Z has $100 of passive income and $200 of general limitation income. Z also has a $60 net operating loss which was carried forward pursuant to section 172 from its 1986 taxable year. The net operating loss resulted from an overall foreign loss attributable to the general limitation income category. Z can demonstrate that the loss is a shipping loss. Therefore, the net operating loss will be treated as a shipping loss for Z's 1988 taxable year. Pursuant to section 904(f)(5), the shipping loss will be allocated as follows: $20 ($60 × 100/300) will be allocated to Z's passive income and $40 ($60 × 200/300) will be allocated to Z's general limitation income. Accordingly, after application of section 904(f), Z has $80 of passive income and $160 of general limitation income for its 1988 taxable year. Although no addition to Z's overall foreign loss account for shipping income will result from the NOL carry forward, shipping income earned by Z in subsequent taxable years, will be subject to recharacterization as a passive income and general limitation income pursuant to the rules set forth in section 904(f)(5).

(c) *Treatment of overall foreign losses that are part of net operating losses incurred in post-effective date taxable years which are carried back to pre-effective date taxable years*—(1) *Allocation to analogous income category*. An overall foreign loss that is part of a net operating loss incurred by the taxpayer in a post-effective date taxable year which is carried back, pursuant to section 172, to a pre-effective date taxable year shall be allocated first to income in the pre-effective date income category analogous to the income category set forth in section 904(d) as in effect for post-effective date taxable years in which the loss occurred. Except for the general limitation income category, the pre-effective date income category that is analogous to a post-effective date income category shall be determined under paragraphs (a)(1) (i) through (iv) of this section. The general limitation income category for pre-effective date years shall be treated as the income category that is analogous to the post-effective date categories for general limitation income, financial services income, shipping income, dividends from each noncontrolled section 902 corporation and high withholding tax interest income. If the net operating loss resulted from separate limitation losses in more than one post-effective date income category and more than one loss is carried back to pre-effective date general limitation income, then the losses shall be allocated to the pre-effective date general limitation income based on the following formula:

$$\text{Pre-effective date general limitation income} \times \frac{\text{Loss in each post-effective date separate limitation category that is analogous to pre-effective date general limitation income}}{\text{Losses in all post-effective categories that are analogous to pre-effective date general limitation income}}$$

(2) *Allocation to U.S. source income*. If an overall foreign loss is carried back to a pre-effective date taxable year and the loss exceeds the foreign source income in the analogous category for the carry back year, the remaining loss shall be allocated against U.S. source income as set forth in §1.904(f)–3. The amount of the loss that offsets U.S. source income must be added to the taxpayer's overall foreign loss account. An addition to an overall foreign loss account resulting from the carry back of a net operating loss incurred by a

taxpayer in a post-effective date taxable year shall be treated as having been incurred by the taxpayer in the year in which the loss arose and shall be subject to recapture pursuant to section 904(f) as in effect for post-effective date taxable years.

(3) *Allocation to other separate limitation categories.* To the extent that an overall foreign loss that is carried back as part of a net operating loss exceeds the separate limitation income to which it is allocated and the U.S. source income of the taxpayer for the taxable year to which the loss is carried, the loss shall be allocated pro rata to other separate limitation income of the taxpayer for the taxable year. However, there shall be no recharacterization of separate limitation income pursuant to section 904(f)(5) as a result of the alloction of such a net operating loss to other separate limitation income of the taxpayer.

(4) *Examples.* The following examples illustrate the rules of paragraph (c) of this section.

Example 1. X is a domestic corporation which has a branch operation in Country A. For its taxable year ending December 31, 1987, X has a $60 net operating loss which is carried back pursuant to section 172 to its taxable year ending December 31, 1985. The net operating loss resulted from a shipping loss; X had no U.S. source income in 1987. X had $20 of general limitation income, $40 of DISC limitation income and $10 of U.S. source income for its 1985 taxable year. The $60 NOL is allocated first to X's 1985 general limitation income to the extent thereof ($20) since the general limitation income category of section 904(d) as in effect for pre-effective date taxable years is the income category that is analogous to shipping income for post-effective date taxable years. Therefore, X has no general limitation income for its 1985 taxable year. Next, pursuant to section 904(f) as in effect for pre-effective date taxable years, the remaining $40 of the NOL is allocated first to X's $10 of U.S. source income and then to $30 of X's DISC limitation income for its 1985 taxable year. Accordingly, X has no U.S. source income and $10 of DISC limitation income for its 1985 taxable year after allocation of the NOL. X has a $10 balance in its shipping overall foreign loss account which is subject to recapture pursuant to section 904(f) as in effect for post-effective date taxable years. X will not be required to recharacterize, pursuant to section 904(f)(5), subsequent shipping income as DISC limitation income.

Example 2. Y is a domestic corporation which has a branch operation in Country B. For its taxable year ending December 31, 1987, X has a $200 net operating loss which is carried back pursuant to section 172 to its taxable year ending December 31, 1986. The net operating loss resulted from a ($100) general limitation loss and a ($100) shipping loss. Y had $100 of general limitation income and $200 of U.S. source income for its taxable year ending December 31, 1986. The separate limitation losses for 1987 are allocated pro rata to Y's 1986 general limitation income as follows: $50 of the ($100) general limitation loss ($100 × 100/200) and $50 of the ($100) shipping loss ($100 × 100/200) is allocated to Y's $100 of 1986 general limitation income. The remaining $50 of Y's general limitation loss and the remaining $50 of Y's shipping loss are allocated to Y's 1986 U.S. source income. Accordingly, Y has no foreign source income and $100 of U.S. source income for its 1986 taxable year. Y has a $50 balance in its general limitation overall foreign loss account and a $50 balance in its shipping overall foreign loss account, both of which will be subject to recapture pursuant to section 904(f) as in effect for post-effective date taxable years.

(d) *Recapture of FORI and general limitation overall foreign losses incurred in taxable years beginning before January 1, 1983.* For taxable years beginning after December 31, 1986, and before January 1, 1991, the rules set forth in §1.904 (f)–6 shall apply for purposes of recapturing general limitation and foreign oil related income (FORI) overall foreign losses incurred in taxable years beginning before January 1, 1983 (pre-1983). For taxable years beginning after December 31, 1990, the rules set forth in this section shall apply for purposes of recapturing pre-1983 general limitation and FORI overall foreign losses.

(e) *Recapture of pre-1983 overall foreign losses determined on a combined basis.* The rules set forth in paragraph (a)(2) of this section shall apply for purposes of recapturing overall foreign losses incurred in taxable years beginning before January 1, 1983, that were computed on a combined basis in accordance with §1.904 (f)–1(c) (1).

(f) *Transition rules for taxable years beginning before December 31, 1990.* For transition rules for taxable years beginning before January 1, 1990, see 26 CFR 1.904 (f)–13T as it appeared in the Code of Federal Regulations revised as of April 1, 1990.

(g) *Recapture in years beginning after December 31, 2002, of separate limitation losses and overall foreign losses incurred in years beginning before January 1, 2003, with respect to the separate category for dividends from a noncontrolled section 902 corporation*—(1) *Recapture of separate limitation loss or overall foreign loss in a separate category for dividends from a noncontrolled section 902 corporation.* To the extent that a taxpayer has a balance in any separate limitation loss or overall foreign loss account in a separate category for dividends from a noncontrolled section 902 corporation under section 904(d)(1)(E) (prior to its repeal by Public Law 108–357, 118 Stat. 1418 (October 22, 2004)) at the end of the taxpayer's last taxable year beginning before January 1, 2003 (or a later taxable year in which the taxpayer received a dividend subject to a separate limitation for dividends from that noncontrolled section 902 corporation), the amount of such balance shall be allocated on the first day of the taxpayer's next taxable year to the taxpayer's other separate categories. The amount of such balance shall be allocated in the same percentages as the taxpayer properly characterized the stock of the noncontrolled section 902 corporation for purposes of apportioning the taxpayer's interest expense for its first taxable year ending after the first day of such corporation's first taxable year beginning after December 31, 2002, under §1.861–12T(c)(3) or §1.861–12(c)(4), as the case may be. To the extent a taxpayer has a balance in any separate limitation loss account in a separate category for dividends from a noncontrolled section 902 corporation with respect to another separate category, and the separate limitation loss would otherwise be assigned to that other category under this paragraph (g)(1), such balance shall be eliminated.

(2) *Recapture of separate limitation loss in another separate category.* To the extent that a taxpayer has a balance in any separate limitation loss account in a separate category with respect to a separate category for dividends from a noncontrolled section 902 corporation under section 904(d)(1)(E) (prior to its repeal by Public Law 108–357, 118 Stat. 1418 (October 22, 2004)) at the end of the taxpayer's last taxable year with or within which ends the last taxable year of the noncontrolled section 902 corporation beginning before January 1, 2003, such loss shall be recaptured in subsequent taxable years as income in the appropriate separate categories. The separate limitation loss shall be recaptured as income in other separate categories in the same percentages as the taxpayer properly characterizes the stock of the noncontrolled section 902 corporation for purposes of apportioning the taxpayer's interest expense in its first taxable year ending after the first day of the foreign corporation's first taxable year beginning after December 31, 2002, under §1.861–12T(c)(3) or §1.861–12(c)(4), as the case may be. To the extent a taxpayer has a balance in a separate limitation loss account in a separate category that would have been recaptured as income in that same category under this paragraph (g)(2), such balance shall be eliminated.

(3) *Exception.* Where a taxpayer formerly met the stock ownership requirements of section 902(a) with respect to a foreign corporation, but did not meet the requirements of section 902(a) on December 20, 2002 (or on the first day of the taxpayer's first taxable year beginning after December 31, 2002, in the case of a transaction that was the subject of a binding contract in effect on December 20, 2002), if the taxpayer has a balance in any separate limitation loss or overall foreign loss account for a separate category for dividends from that foreign corporation under section 904(d)(1)(E) (prior to its repeal by Public Law 108–357, 118 Stat. 1418 (October 22, 2004)) at the end of the taxpayer's last taxable year beginning before January 1, 2003, then the amount of such balance shall not be subject to recapture under section 904(f) and this section. If a separate limitation loss or overall foreign loss account for such category is not subject to recapture under this paragraph (g)(3), the taxpayer cannot carry over any unused foreign taxes in such separate category to any other limitation category. However, a taxpayer may elect to recapture the balances of all separate limitation loss and overall foreign loss accounts for all separate

categories for dividends from such formerly-owned noncontrolled section 902 corporations under the rules of paragraphs (g)(1) and (2) of this section. If a taxpayer so elects, it may carry over any unused foreign taxes in these separate categories to the appropriate separate categories as provided in §1.904–2(h).

(4) *Examples*. The following examples illustrate the application of this paragraph (g):

Example 1. X is a domestic corporation that meets the ownership requirements of section 902(a) with respect to Y, a foreign corporation the stock of which X owns 50 percent. Therefore, Y is a noncontrolled section 902 corporation with respect to X. Both X and Y use the calendar year as their taxable year. As of December 31, 2002, X had a $100 balance in its separate limitation loss account for the separate category for dividends from Y, of which $60 offset general limitation income and $40 offset passive income. For purposes of apportioning X's interest expense for its 2003 taxable year, X properly characterized the stock of Y as a multiple category asset (80% general and 20% passive). Under paragraph (g)(1) of this section, on January 1, 2003, $80 ($100 × 80/100) of the $100 balance in the separate limitation loss account is assigned to the general limitation category. Of this $80 balance, $32 ($80 × 40/100) is with respect to the passive category, and $48 ($80 × 60/100) is with respect to the general limitation category and therefore is eliminated. The remaining $20 balance ($100 × 20/100) of the $100 balance is assigned to the passive category. Of this $20 balance, $12 ($20 × 60/100) is with respect to the general limitation category, and $8 ($20 × 40/100) is with respect to the passive category and therefore is eliminated.

Example 2. The facts are the same as in *Example 1*, except that as of December 31, 2002, X had a $30 balance in its separate limitation loss account in the general limitation category, and a $20 balance in its separate limitation loss account in the passive category, both of which offset income in the separate category for dividends from Y. Under paragraph (g)(2) of this section, the separate limitation loss accounts in the general limitation and passive categories with respect to the separate category for dividends from Y will be recaptured on and after January 1, 2003, from income in other separate categories, as follows. Of the $30 balance in X's separate limitation loss account in the general category with respect to the separate category for dividends from Y, $6 ($30 × 20/100) is with respect to the passive category, and $24 ($30 × 80/100) is with respect to the general limitation category and therefore is eliminated. Of the $20 balance in X's separate limitation loss account in the passive category with respect to the separate category for dividends from Y, $16 ($20 × 80/100) will be recaptured out of general limitation income, and $4 ($20 × 20/100) would otherwise be recaptured out of passive income and therefore is eliminated.

(5) *Effective/applicability date*. This paragraph (g) applies to taxable years ending on or after April 20, 2009. *See* 26 CFR 1.904(f)–12T(g) (revised as of April 1, 2009) for rules applicable to taxable years beginning after December 31, 2002, and ending before April 20, 2009.

(h) *Recapture in years beginning after December 31, 2006, of separate limitation losses and overall foreign losses incurred in years beginning before January 1, 2007*—(1) *Losses related to pre-2007 separate categories for passive income, certain dividends from a DISC or former DISC, taxable income attributable to certain foreign trade income or certain distributions from a FSC or former FSC*—(i) *Recapture of separate limitation loss or overall foreign loss incurred in a pre-2007 separate category for passive income, certain dividends from a DISC or former DISC, taxable income attributable to certain foreign trade income or certain distributions from a FSC or former FSC*. To the extent that a taxpayer has a balance in any separate limitation loss or overall foreign loss account in a pre-2007 separate category (as defined in §1.904–7(g)(1)(ii)) for passive income, certain dividends from a DISC or former DISC, taxable income attributable to certain foreign trade income or certain distributions from a FSC or former FSC, at the end of the taxpayer's last taxable year beginning before January 1, 2007, the amount of such balance, or balances, shall be allocated on the first day of the taxpayer's next taxable year to the taxpayer's post-2006 separate category (as defined in §1.904–7(g)(1)(iii)) for passive category income.

(ii) *Recapture of separate limitation loss with respect to a pre-2007 separate category for passive income, certain dividends from a DISC or former DISC, taxable income attributable to certain foreign trade income or certain distributions from a FSC or former FSC*. To the extent that a taxpayer has a balance in any separate limitation loss account in any pre-2007 separate category with respect to a pre-2007 separate category for passive income, certain dividends from a DISC

or former DISC, taxable income attributable to certain foreign trade income or certain distributions from a FSC or former FSC at the end of the taxpayer's last taxable year beginning before January 1, 2007, such loss shall be recaptured in subsequent taxable years as income in the post-2006 separate category for passive category income.

(2) *Losses related to pre-2007 separate categories for shipping, financial services income or general limitation income*—(i) *Recapture of separate limitation loss or overall foreign loss incurred in a pre-2007 separate category for shipping income, financial services income or general limitation income.* To the extent that a taxpayer has a balance in any separate limitation loss or overall foreign loss account in a pre-2007 separate category for shipping income, financial services income or general limitation income at the end of the taxpayer's last taxable year beginning before January 1, 2007, the amount of such balance, or balances, shall be allocated on the first day of the taxpayer's next taxable year to the taxpayer's post-2006 separate category for general category income.

(ii) *Recapture of separate limitation loss with respect to a pre-2007 separate category for shipping income, financial services income or general limitation income.* To the extent that a taxpayer has a balance in any separate limitation loss account in any pre-2007 separate category with respect to a pre-2007 separate category for shipping income, financial services income or general limitation income at the end of the taxpayer's last taxable year beginning before January 1, 2007, such loss shall be recaptured in subsequent taxable years as income in the post-2006 separate category for general category income.

(3) *Losses related to a pre-2007 separate category for high withholding tax interest*—(i) *Recapture of separate limitation loss or overall foreign loss incurred in a pre-2007 separate category for high withholding tax interest.* To the extent that a taxpayer has a balance in any separate limitation loss or overall foreign loss account in a pre-2007 separate category for high withholding tax interest at the end of the taxpayer's last taxable year beginning before January 1, 2007, the amount of such balance shall be allocated on the first day of the taxpayer's next taxable year on a pro rata basis to the taxpayer's post-2006 separate categories for general category and passive category income, based on the proportion in which any unused foreign taxes in the same pre-2007 separate category for high withholding tax interest are allocated under §1.904–2(i)(1). If the taxpayer, other than a financial services entity as defined in §1.904–4(e)(3), has no unused foreign taxes in the pre-2007 separate category for high withholding tax interest, then any loss account balance in that category shall be allocated to the post-2006 separate category for passive category income. If the taxpayer is a financial services entity, as defined in §1.904–4(e)(3), and has no unused foreign taxes in the pre-2007 separate category for high withholding tax interest, then any loss account balance in that category shall be allocated to the post-2006 separate category for general category income.

(ii) *Recapture of separate limitation loss with respect to a pre-2007 separate category for high withholding tax interest.* To the extent that a taxpayer has a balance in a separate limitation loss account in any pre-2007 separate category with respect to a pre-2007 separate category for high withholding tax interest at the end of the taxpayer's last taxable year beginning before January 1, 2007, such loss shall be recaptured in subsequent taxable years on a pro rata basis as income in the post-2006 separate categories for general category and passive category income, based on the proportion in which any unused foreign taxes in the pre-2007 separate category for high withholding tax interest are allocated under §1.904–2(i)(1). If the taxpayer, other than a financial services entity as defined in §1.904–4(e)(3), has no unused foreign taxes in the pre-2007 separate category for high withholding tax interest, then the loss account balance shall be recaptured in subsequent taxable years solely as income in the post-2006 separate category for passive category income. If the taxpayer is a financial services entity, as defined in §1.904–4(e)(3), and has no unused foreign taxes in the pre-2007 separate category for high withholding tax interest, then the loss account balance shall be recaptured in

subsequent taxable years solely as income in the post-2006 separate category for general category income.

(4) *Elimination of certain separate limitation loss accounts.* After application of paragraphs (h)(1) through (h)(3) of this section, any separate limitation loss account allocated to the post-2006 separate category for passive category income for which income is to be recaptured as passive category income, as determined under those same provisions, shall be eliminated. Similarly, after application of paragraphs (h)(1) through (h)(3) of this section, any separate limitation loss account allocated to the post-2006 separate category for general category income for which income is to be recaptured as general category income, as determined under those same provisions, shall be eliminated.

(5) *Alternative method.* In lieu of applying the rules of paragraphs (h)(1) through (h)(3) of this section, a taxpayer may apply the principles of paragraphs (g)(1) and (g)(2) of this section to determine recapture in taxable years beginning after December 31, 2006, of separate limitation losses and overall foreign losses incurred in taxable years beginning before January 1, 2007. A taxpayer may choose to use the alternative method on a timely filed (original or amended) tax return or during an audit. A taxpayer that uses the alternative method on an amended return or in the course of an audit must make appropriate adjustments to eliminate any double benefit arising from application of the alternative method to years that are not open for assessment. A taxpayer's choice to use the alternative method is evidenced by employing the method. The taxpayer need not file any separate statement.

(6) *Effective/applicability date.* This paragraph (h) shall apply to taxable years beginning after December 31, 2006, and ending on or after December 21, 2007. However, taxpayers may choose to apply 26 CFR 1.904(f)–12T(h) as it appeared in the Code of Federal Regulations as of April 1, 2010, in lieu of this paragraph (h) to taxable years beginning after December 31, 2006 and ending on or after December 21, 2007, but ending before April 7, 2011 provided that appropriate adjustments are made to eliminate duplicate benefits arising from application of 26 CFR 1.904(f)–12T(h) to taxable years that are not open for assessment. In addition, if a taxpayer that is a financial services entity (as defined in §1.904–4(e)(3)) chooses to apply 26 CFR 1.904(f)–12T(h) to taxable years ending before April 7, 2011, then as of the beginning of the taxpayer's first taxable year ending on or after April 7, 2011 any remaining balance in a passive category loss account that is attributable to a loss account in a pre-2007 separate category for high withholding tax interest shall be allocated to the general category or eliminated pursuant to §1.904(f)–12(h)(4), and any remaining balance in a separate limitation loss account with respect to passive category income that is attributable to a loss account with respect to a pre-2007 separate category for high withholding tax interest will be recaptured in such year and subsequent taxable years as general category income or eliminated pursuant to §1.904(f)–12(h)(4).

[T.D. 8306, 55 FR 31381, Aug. 2, 1990, as amended by T.D. 9260, 71 FR 24539, Apr. 25, 2006; T.D. 9368, 72 FR 72591, Dec. 21, 2007; T.D. 9452, 74 FR 27886, June 11, 2009; T.D. 9521, 76 FR 19273, Apr. 7, 2011]

§1.904(g)–0 Outline of regulation provisions.

This section lists the headings for §§1.904(g)–1 through 1.904(g)–3.

§1.904(g)–1 Overall domestic loss and the overall domestic loss account.

(a) Overview of regulations.
(b) Overall domestic loss accounts.
(1) In general.
(2) Taxable year in which overall domestic loss is sustained.
(c) Determination of a taxpayer's overall domestic loss.
(1) Overall domestic loss defined.
(2) Domestic loss defined.
(3) Qualified taxable year defined.
(4) Method of allocation and apportionment of deductions.
(d) Additions to overall domestic loss accounts.
(1) General rule.
(2) Overall domestic loss of another taxpayer.
(3) Adjustments for capital gains and losses.
(e) Reductions of overall domestic loss accounts.

(1) Pre-recapture reduction for amounts allocated to other taxpayers.
(2) Reduction for amounts recaptured.
(f) Effective/applicability date.

§ 1.904(g)–2 Recapture of overall domestic losses.

(a) In general.
(b) Determination of U.S. source taxable income for purposes of recapture.
(c) Section 904(g)(1) recapture.
(d) Effective/applicability date.

§ 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 recapture of separate limitation losses, overall foreign losses, and overall domestic losses.

(a) In general.
(b) Step One: Allocation of net operating loss and net capital loss carryovers.
(1) In general.
(2) Full net operating loss carryover.
(3) Partial net operating loss carryover.
(4) Net capital loss carryovers.
(c) Step Two: Section 904(b) adjustments.
(d) Step Three: Allocation of separate limitation losses.
(e) Step Four: Allocation of U.S. source losses.
(f) Step Five: Recapture of overall foreign loss accounts.
(g) Step Six: Recapture of separate limitation loss accounts.
(h) Step Seven: Recapture of overall domestic loss accounts.
(i) [Reserved]
(j) Examples.
(k) Effective/applicability date.

[T.D. 9371, 72 FR 72599, Dec. 21, 2007, as amended by T.D. 9595, 77 FR 37580, June 22, 2012]

§ 1.904(g)–1 Overall domestic loss and the overall domestic loss account.

(a) *Overview of regulations.* This section provides rules for determining a taxpayer's overall domestic losses, for establishing overall domestic loss accounts, and for making additions to and reducing such accounts for purposes of section 904(g). Section 1.904(g)–2 provides rules for recapturing the balance in any overall domestic loss account under the general recharacterization rule of section 904(g)(1). Section 1.904(g)–3 provides ordering rules for the allocation of net operating losses, net capital losses, U.S. source losses, and separate limitation losses, and the recapture of separate limitation losses, overall foreign losses and overall domestic losses.

(b) *Overall domestic loss accounts*—(1) *In general.* Any taxpayer that sustains an overall domestic loss under paragraph (c) of this section must establish an overall domestic loss account for such loss with respect to each separate category, as defined in § 1.904(f)–7(b)(1), of the taxpayer in which foreign source income is offset by the domestic loss. The balance in each overall domestic loss account represents the amount of such overall domestic loss subject to recapture in a given taxable year. From year to year, amounts may be added to or subtracted from the balances in such loss accounts as provided in paragraphs (d) and (e) of this section.

(2) *Taxable year in which overall domestic loss is sustained.* When a domestic loss is carried back or carried forward as part of a net operating loss, and offsets foreign source income in a carryover year, the resulting overall domestic loss is treated as sustained in the later of the year in which the domestic loss was incurred or the year to which the loss was carried. Accordingly, when a taxpayer incurs a domestic loss that is carried back as part of a net operating loss to offset foreign source income in a qualified taxable year, as defined in paragraph (c)(3) of this section, the resulting overall domestic loss is treated as sustained in the later year in which the domestic loss was incurred and not in the earlier year in which the loss offset foreign source income. In addition, when a taxpayer incurs a domestic loss that is carried forward as part of a net operating loss and applied to offset foreign source income in a later taxable year, the resulting overall domestic loss is treated as sustained in the later year in which the domestic loss offsets foreign source income and not in the earlier year in which the loss was incurred. For example, if a taxpayer incurs a domestic loss in the 2007 taxable year that is carried back to the 2006 qualified taxable year and offsets foreign source income in 2006, the resulting overall domestic loss is treated as sustained in the 2007 taxable year. If a taxpayer incurs a domestic loss in a pre-2007 taxable year that

is carried forward to a post-2006 qualified taxable year and offsets foreign source income in the post-2006 year, the resulting overall domestic loss is treated as sustained in the post-2006 year. An overall domestic loss account is established, or increased under paragraph (d) of this section, at the end of the taxable year in which the overall domestic loss is treated as sustained and will be recaptured from U.S. source income arising in subsequent taxable years.

(c) *Determination of a taxpayer's overall domestic loss*—(1) *Overall domestic loss defined.* For taxable years beginning after December 31, 2006, a taxpayer sustains an overall domestic loss—

(i) In any qualified taxable year in which its domestic loss for such taxable year offsets foreign source taxable income for the taxable year or for any preceding qualified taxable year by reason of a carryback; and

(ii) In any other taxable year in which the domestic loss for such taxable year offsets foreign source taxable income for any preceding qualified taxable year by reason of a carryback.

(2) *Domestic loss defined.* For purposes of this section and §§1.904(g)–2 and 1.904(g)–3, the term *domestic loss* means the amount by which the U.S. source gross income for the taxable year is exceeded by the sum of the expenses, losses, and other deductions properly apportioned or allocated to such income, taking into account any net operating loss carried forward from a prior taxable year, but not any loss carried back. If a taxpayer has any capital gains or losses or qualified dividend income, as defined in section 1(h)(11), the amount of the taxpayer's domestic loss that offsets foreign source income must be determined taking into account adjustments under section 904(b)(2). See §1.904(g)–1(d)(3) for further guidance.

(3) *Qualified taxable year defined.* For purposes of this section and §§1.904(g)–2 and 1.904(g)–3, the term *qualified taxable year* means any taxable year for which the taxpayer chooses the benefits of section 901.

(4) *Method of allocation and apportionment of deductions.* In determining its overall domestic loss, a taxpayer shall allocate and apportion expenses, losses, and other deductions to U.S. source gross income in accordance with sections 861(b) and 865 and the regulations thereunder, including §§1.861–8 through 1.861–14T.

(d) *Additions to overall domestic loss accounts*—(1) *General rule.* A taxpayer's overall domestic loss as determined under paragraph (c) of this section shall be added to the applicable overall domestic loss account at the end of its taxable year to the extent that the overall domestic loss either reduces foreign source income for the year (but only if such year is a qualified taxable year) or reduces foreign source income for a qualified taxable year to which the loss has been carried back.

(2) *Overall domestic loss of another taxpayer.* If any portion of any overall domestic loss of another taxpayer is allocated to the taxpayer in accordance with §1.1502–9 (relating to consolidated overall domestic losses) the taxpayer shall add such amount to its applicable overall domestic loss account.

(3) *Adjustments for capital gains and losses.* If the taxpayer has capital gains or losses or qualified dividend income, the amount by which a domestic loss is considered to reduce foreign source income in a taxable year shall equal the section 904(f)(5)(D) amount determined under §1.904(b)–1(h)(1)(iii), regardless of the amount of domestic loss that was determined before taking any section 904(b)(2) adjustments into account.

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

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

(2) *Reduction for amounts recaptured.* An overall domestic loss account is reduced by the amount of any U.S. source income that is recharacterized in accordance with §1.904(g)–2(c) (relating to recapture under section 904(g)(1)).

(f) *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)–1T (revised as of April 1, 2010).

[T.D. 9595, 77 FR 37580, June 22, 2012]

§ 1.904(g)–2 Recapture of overall domestic losses.

(a) *In general.* A taxpayer shall recapture an overall domestic loss as provided in this section. Recapture is accomplished by treating a portion of the taxpayer's U.S. source taxable income as foreign source income. The recharacterized income is allocated among and increases foreign source income in separate categories in proportion to the balances of the overall domestic loss accounts with respect to those separate categories. As a result, if the taxpayer chooses the benefits of section 901, the taxpayer's foreign tax credit limitation is increased. As provided in § 1.904(g)–1(e)(2), the balance in a taxpayer's overall domestic loss account with respect to a separate category is reduced at the end of each taxable year by the amount of loss recaptured during that taxable year. Recapture continues until the amount of U.S. source income recharacterized as foreign source income equals the amount in the overall domestic loss account.

(b) *Determination of U.S. source taxable income for purposes of recapture.* For purposes of determining the amount of an overall domestic loss subject to recapture, the taxpayer's taxable income from U.S. sources shall be computed in accordance with the rules set forth in § 1.904(g)–1(c)(4). U.S. source taxable income shall be determined by taking into account adjustments for capital gains and losses and qualified dividend income in a similar manner to the adjustments made to foreign source taxable income under section 904(b)(2) and § 1.904(b)–1, following the principles of § 1.904(b)–1(h)(1)(i).

(c) *Section 904(g)(1) recapture.* The amount of any U.S. source taxable income subject to recharacterization in a taxable year in which paragraph (a) of this section applies is the lesser of the 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 × $100/$300) of the U.S. loss is allocated to general category income and $60 ($90 × $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 operating 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 × $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 × $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

(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

(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 regulations must be used in the determination of an affiliate's net taxable income or loss in a separate category.

(ii) The net taxable income amounts in each separate category determined under paragraph (a)(1)(i) of this section are combined for all affiliates to determine one amount for the group of affiliates in each separate category. However, a net loss of an affiliate (first affiliate) in a separate category determined under paragraph (a)(1)(i) of this section will be combined under this paragraph (a) with net income or loss amounts of other affiliates in the same category only if, and to the extent that, the net loss offsets taxable income, whether U.S. or foreign source, of the first affiliate. The consolidated return regulations that apply the principles of sections 904(f) and 907(c)(4) to consolidated groups will then be applied to the combined amounts in each separate category as if all affiliates were members of a single consolidated group.

(2) *Allocation.* Any net taxable income in a separate category calculated under paragraph (a)(1)(ii) of this section for purposes of the foreign tax credit provisions must then be allocated among the affiliates under any consistently applied reasonable method, taking into account all of the facts and circumstances. A method is consistently applied if used by all affiliates from year to year. Once chosen, an allocation method may be changed only with the consent of the Commissioner. This allocation will only affect the source and foreign tax credit separate limitation character of the income for purposes of the foreign tax credit separate limitation of each affiliate, and will not otherwise affect an affiliate's total net income or loss. This section applies whether the federal income tax consequences of its application favor, or are adverse to, the taxpayer.

(b) *Definitions and special rules* For purposes of this section only, the following terms will have the meanings specified.

(1) *Affiliate*—(i) *Generally.* Affiliates are includible corporations—

(A) That are members of the same affiliated group, as defined in section 1504(a); or

(B) That would be members of the same affiliated group, as defined in section 1504(a) if—

(*1*) Any non-includible corporation meeting the ownership test of section 1504(a)(2) with respect to any such includible corporation was itself an includible corporation; or

(*2*) The constructive ownership rules of section 1563(e) were applied for purposes of section 1504(a).

(ii) *Rules for consolidated groups.* Affiliates that are members of the same consolidated group are treated as a single affiliate for purposes of this section. The provisions of paragraph (a) of this section shall not apply if the only affiliates under this definition are already members of the same consolidated group without operation of this section.

(iii) *Exception for newly acquired affiliates*—(A) With respect to acquisitions after December 7, 1995, an includible corporation acquired from unrelated third parties (First Corporation) will not be considered an affiliate of another includible corporation (Second Corporation) during the taxable year of the First Corporation beginning before the date on which the First Corporation originally becomes an affiliate with respect to the Second Corporation.

(B) With respect to acquisitions on or before December 7, 1995, an includible corporation acquired from unrelated third parties will not be considered an affiliate of another includible corporation during its taxable year beginning before the date on which the first includible corporation first becomes an affiliate with respect to that other includible corporation.

(C) This exception does not apply where the acquisition of an includible corporation is used to avoid the application of this section.

(2) *Includible corporation.* The term *includible corporation* has the same meaning it has in section 1504(b).

(c) *Taxable years.* If all of the affiliates use the same U.S. taxable year, then that taxable year must be used for purposes of applying this section. If, however, the affiliates use more than one U.S. taxable year, then an appropriate taxable year must be used for applying this section. The determination whether a taxable year is appropriate must take into account all of the relevant facts and circumstances, including the U.S. taxable years used by the affiliates for general U.S. income tax purposes. The taxable year chosen by the affiliates for purposes of applying this section must be used consistently from year to year. The taxable year may be changed only with the prior consent of the Commissioner. Those affiliates that do not use the year determined under this paragraph (c) as their U.S. taxable year for general U.S. income tax purposes must, for purposes of this section, use their U.S. taxable year or years ending within the taxable year determined under this paragraph (c). If, however, the stock of an affiliate is disposed of so that it ceases to be an affiliate, then the taxable year of that affiliate will be considered to end on the disposition date for purposes of this section.

(d) *Consistent treatment of foreign taxes paid.* All affiliates must consistently either elect under section 901(a) to claim a credit for foreign income taxes paid or accrued, or deemed paid or accrued, or deduct foreign taxes paid or accrued under section 164. See also § 1.1502–4(a); § 1.905–1(a).

(e) *Effective date.* Except as provided in paragraph (b)(1)(iii) of this section (relating to newly acquired affiliates), this section is effective for taxable years of affiliates beginning after December 31, 1993.

[T.D. 8627, 60 FR 56119, Nov. 7, 1995]

§ 1.904(j)–0 Outline of regulation provisions.

This section lists the headings for § 1.904(j)–1.

§ 1.904(j)–1 Certain individuals exempt from foreign tax credit limitation.

(a) Election available only if all foreign taxes are creditable foreign taxes.

(b) Coordination with carryover rules.

(1) No carryovers to or from election year.

(2) Carryovers to and from other years determined without regard to election years.

(3) Determination of amount of creditable foreign taxes.

(c) Examples.

(d) Effective date.

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

§ 1.904(j)–1 Certain individuals exempt from foreign tax credit limitation.

(a) *Election available only if all foreign taxes are creditable foreign taxes.* A taxpayer may elect to apply section 904(j) for a taxable year only if all of the taxes for which a credit is allowable to the taxpayer under section 901 for the taxable year (without regard to carryovers) are creditable foreign taxes (as defined in section 904(j)(3)(B)).

(b) *Coordination with carryover rules*—(1) *No carryovers to or from election year.* If the taxpayer elects to apply section 904(j) for any taxable year, then no taxes paid or accrued by the taxpayer during such taxable year may be deemed paid or accrued under section 904(c) in any other taxable year, and no taxes paid or accrued in any other taxable year may be deemed paid or accrued under section 904(c) in such taxable year.

(2) *Carryovers to and from other years determined without regard to election years.* The amount of the foreign taxes paid or accrued, and the amount of the foreign source taxable income, in any year for which the taxpayer elects to apply section 904(j) shall not be taken into account in determining the amount of any carryover to or from any other taxable year. However, an election to apply section 904(j) to any year does not extend the number of taxable years to which unused foreign taxes may be carried under section 904(c) and § 1.904–2(b). Therefore, in determining the number of such carryover years, the taxpayer must take into account years to which a section 904(j) election applies.

(3) *Determination of amount of creditable foreign taxes.* Otherwise allowable carryovers of foreign tax credits from other taxable years shall not be taken into account in determining whether the amount of creditable foreign taxes paid or accrued by an individual during a taxable year exceeds $300 ($600 in the case of a joint return) for purposes of section 904(j)(2)(B).

(c) *Examples.* The following examples illustrate the provisions of this section:

Example 1. In 2006, X, a single individual using the cash basis method of accounting for income and foreign tax credits, pays $100 of foreign taxes with respect to general limitation income that was earned and included in income for United States tax purposes in 2005. The foreign taxes would be creditable under section 901 but are not shown on a payee statement furnished to X. X's only income for 2006 from sources outside the United States is qualified passive income, with respect to which X pays $200 of creditable foreign taxes shown on a payee statement. X may not elect to apply section 904(j) for 2006 because some of X's foreign taxes are not creditable foreign taxes within the meaning of section 904(j)(3)(B).

Example 2. (i) In 2009, A, a single individual using the cash basis method of accounting for income and foreign tax credits, pays creditable foreign taxes of $250 attributable to passive income. Under section 904(c), A may also carry forward to 2009 $100 of unused foreign taxes paid in 2005 with respect to passive income, $300 of unused foreign taxes paid in 2005 with respect to general limitation income, $400 of unused foreign taxes paid in 2006 with respect to passive income, and $200 of unused foreign taxes paid in 2006 with respect to general limitation income. In 2009, A's only foreign source income is passive income described in section 904(j)(3)(A)(i), and this income is reported to A on a payee statement (within the meaning of section 6724(d)(2)). If A elects to apply section 904(j) for the 2009 taxable year, the unused foreign taxes paid in 2005 and 2006 are not deemed paid in 2009, and A therefore cannot claim a foreign tax credit for those taxes in 2009.

(ii) In 2010, A again is eligible for and elects the application of section 904(j). The carryforwards from 2005 expire in 2010. The carryforward period established under section 904(c) is not extended by A's election under section 904(j). In 2011, A does not elect the application of section 904(j). The $600 of unused foreign taxes paid in 2006 on passive and general limitation income are deemed paid in 2011, under section 904(c), without any adjustment for any portion of those taxes that might have been used as a foreign tax credit in 2009 or 2010 if A had not elected to apply section 904(j) to those years.

(d) *Effective date.* Section 1.904(j)–1 applies to taxable years beginning after July 20, 2004.

[T.D. 9141, 69 FR 43316, July 20, 2004]

§ 1.905–1 When credit for taxes may be taken.

(a) *In general.* The credit for taxes provided in subpart A (section 901 and following), part III, subchapter N, chapter 1 of the Code, may ordinarily be taken either in the return for the year in which the taxes accrued or in which the taxes were paid, dependent

upon whether the accounts of the taxpayer are kept and his returns filed using an accrual method or using the cash receipts and disbursements method. Section 905(a) allows the taxpayer, at his option and irrespective of the method of accounting employed in keeping his books, to take such credit for taxes as may be allowable in the return for the year in which the taxes accrued. An election thus made under section 905(a) (or under the corresponding provisions of prior internal revenue laws) must be followed in returns for all subsequent years, and no portion of any such taxes accrued in a year in which a credit is claimed will be allowed as a deduction from gross income in any year. See also § 1.905–4.

(b) *Foreign income subject to exchange controls.* If, however, under the provisions of the regulations under section 461, an amount otherwise constituting gross income for the taxable year from sources without the United States is, owing to monetary, exchange, or other restrictions imposed by a foreign country, not includible in gross income of the taxpayer for such year, the credit for income taxes imposed by such foreign country with respect to such amount shall be taken proportionately in any subsequent taxable year in which such amount or portion thereof is includible in gross income.

§ 1.905–2 Conditions of allowance of credit.

(a) *Forms and information.* (1) Whenever the taxpayer chooses, in accordance with paragraph (d) of § 1.901–1, to claim the benefits of the foreign tax credit, the claim for credit shall be accompanied by Form 1116 in the case of an individual or by Form 1118 in the case of a corporation.

(2) The form must be carefully filled in with all the information called for and with the calculations of credits indicated. Except where it is established to the satisfaction of the district director that it is impossible for the taxpayer to furnish such evidence, the taxpayer must provide upon request the receipt for each such tax payment if credit is sought for taxes already paid or the return on which each such accrued tax was based if credit is sought for taxes accrued. The receipt or return must be either the original, a duplicate original, or a duly certified or authenticated copy. The preceding two sentences are applicable for returns whose original due date falls on or after January 1, 1988. Any additional information necessary for the determination under part I (section 861 and following), subchapter N, chapter 1 of the Code, of the amount of income derived from sources without the United States and from each foreign country shall, upon the request of the district director, be furnished by the taxpayer. If the taxpayer upon request fails without justification to furnish any such additional information which is significant, including any significant information which he is requested to furnish pursuant to § 1.861–8(f)(5) as proposed in the FEDERAL REGISTER for November 8, 1976, the District Director may disallow the claim of the taxpayer to the benefits of the foreign tax credit.

(b) *Secondary evidence.* Where it has been established to the satisfaction of the District Director that it is impossible to furnish a receipt for such foreign tax payment, the foreign tax return, or direct evidence of the amount of tax withheld at the source, the District Director, may, in his discretion, accept secondary evidence thereof as follows:

(1) *Receipt for payment.* In the absence of a receipt for payment of foreign taxes there shall be submitted a photostatic copy of the check, draft, or other medium of payment showing the amount and date thereof, with certification identifying it with the tax claimed to have been paid, together with evidence establishing that the tax was paid for taxpayer's account as his own tax on his own income. If credit is claimed on an accrual method, it must be shown that the tax accrued in the taxable year.

(2) *Foreign tax return.* If the foreign tax return is not available, the foreign tax has not been paid, and credit is claimed on an accrual method, there shall be submitted—

(i) A certified statement of the amount shall be submitted—

(ii) Excerpts from the taxpayer's accounts showing amounts of foreign income and tax thereon accrued on its books.

(iii) A computation of the foreign tax based on income from the foreign country carried on the books and at current rates of tax to be established by data such as excerpts from the foreign law, assessment notices, or other documentary evidence thereof.

(iv) A bond, if deemed necessary by the District Director, filed in the manner provided in cases where the foreign return is available, and

(v) In case a bond is not required, a specific agreement wherein the taxpayer shall recognize its liability to report the correct amount of tax when ascertained, as required by the provisions of section 905 (c).

If at any time the foreign tax receipts or foreign tax returns become available to the taxpayer, they shall be promptly submitted to the district director.

(3) *Tax withheld at source.* In the case of taxes withheld at the source from dividends, interest, royalties, compensation, or other form of income, where evidence of withholding and of the amount withheld cannot be secured from those who have made the payments, the district director may, in his discretion, accept secondary evidence of such withholding and of the amount of the tax so withheld, having due regard to the taxpayer's books of account and to the rates of taxation prevailing in the particular foreign country during the period involved.

(c) *Credit for taxes accrued but not paid.* In the case of a credit sought for a tax accrued but not paid, the district director may, as a condition precedent to the allowance of a credit, require a bond from the taxpayer, in addition to Form 1116 or 1118. If such a bond is required, Form 1117 shall be used by an individual or by a corporation. It shall be in such sum as the Commissioner may prescribe, and shall be conditioned for the payment by the taxpayer of any amount of tax found due upon any redetermination of the tax made necessary by such credit proving incorrect, with such further conditions as the district director may require. This bond shall be executed by the taxpayer, or the agent or representative of the taxpayer, as principal, and by sureties satisfactory to and approved by the Commissioner. See also 6 U.S.C. 15.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 7292, 38 FR 33300, Dec. 3, 1973; 38 FR 34802, Dec. 19, 1973; T.D. 7456, 42 FR 1214, Jan. 6, 1977; T.D. 8210, 53 FR 23613, June 23, 1988; T.D. 8412, 57 FR 20653, May 14, 1992; T.D. 8759, 63 FR 3813, Jan. 27, 1998]

§ 1.905–3T Adjustments to United States tax liability and to the pools of post-1986 undistributed earnings and post-1986 foreign income taxes as a result of a foreign tax redetermination (temporary).

(a) *Effective/applicability dates*—(1) *Currency translation.* Except as provided in § 1.905–5T, paragraph (b) of this section applies to taxes paid or accrued in taxable years of United States taxpayers beginning on or after November 7, 2007 and to taxes paid or accrued by a foreign corporation in its taxable years which end with or within a taxable year of the domestic corporate shareholder beginning on or after November 7, 2007. For taxable years beginning after December 31, 1997, and before November 7, 2007, section 986(a), as amended by the Taxpayer Relief Act of 1997 and the American Jobs Creation Act of 2004, shall apply. For taxable years beginning after December 31, 1986, and before January 1, 1998, § 1.905–3T (as contained in 26 CFR part 1, revised as of April 1, 2007) shall apply.

(2) *Foreign tax redeterminations.* Paragraphs (c) and (d) of this section apply to foreign tax redeterminations occurring in taxable years of United States taxpayers beginning on or after November 7, 2007 where the foreign tax redetermination affects the amount of foreign taxes paid or accrued by a United States taxpayer. Where the redetermination of foreign tax paid or accrued by a foreign corporation affects the computation of foreign taxes deemed paid under section 902 or 960 with respect to post-1986 undistributed earnings of the foreign corporation, paragraphs (c) and (d) of this section apply to foreign tax redeterminations occurring in taxable years of a foreign corporation which end with or within a taxable year of the domestic corporate shareholder beginning on or after November 7, 2007. For corresponding rules

applicable to foreign tax redeterminations occurring in taxable years beginning before November 7, 2007, see §§ 1.905–3T and 1.905–5T (as contained in 26 CFR part 1, revised as of April 1, 2007).

(b) *Currency translation rules*—(1) *Translation of foreign taxes taken into account when accrued*—(i) *In general*. Except as provided in paragraph (b)(1)(ii) of this section, in the case of a taxpayer or a member of a qualified group (as defined in section 902(b)(2)) that takes foreign income taxes into account when accrued, the amount of any foreign taxes denominated in foreign currency that have been paid or accrued, additional tax liability denominated in foreign currency, taxes withheld in foreign currency, or estimated taxes paid in foreign currency shall be translated into dollars using the average exchange rate (as defined in § 1.989(b)–1) for the United States taxable year to which such taxes relate.

(ii) *Exceptions*—(A) *Taxes not paid within two years*. Any foreign income taxes denominated in foreign currency that are paid more than two years after the close of the United States taxable year to which they relate shall be translated into dollars using the exchange rate as of the date of payment of the foreign taxes. To the extent any accrued foreign income taxes denominated in foreign currency remain unpaid two years after the close of the taxable year to which they relate, see paragraph (b)(3) of this section for translation rules for the required adjustments.

(B) *Taxes paid before taxable year begins*. Any foreign income taxes paid before the beginning of the United States taxable year to which such taxes relate shall be translated into dollars using the exchange rate as of the date of payment of the foreign taxes.

(C) *Inflationary currency*. Any foreign income taxes the liability for which is denominated in any inflationary currency shall be translated into dollars using the exchange rate as of the date of payment of the foreign taxes. For this purpose, the term *inflationary currency* means the currency of a country in which there is cumulative inflation during the base period of at least 30 percent, as determined by reference to the consumer price index of the country listed in the monthly issues of International Financial Statistics, or a successor publication, of the International Monetary Fund. For purposes of this paragraph (b)(1)(ii)(C), *base period* means, with respect to any taxable year, the thirty-six calendar months immediately preceding the last day of such taxable year (see § 1.985–1(b)(2)(ii)(D)). Accrued but unpaid taxes denominated in an inflationary currency shall be translated into dollars at the exchange rate on the last day of the United States taxable year to which such taxes relate.

(D) *Election to translate taxes using exchange rate for date of payment*. A taxpayer that is otherwise required to translate foreign income taxes that are denominated in foreign currency using the average exchange rate may elect to translate foreign income taxes described in this paragraph (b)(1)(ii)(D) into dollars using the exchange rate as of the date of payment of the foreign taxes, provided that the liability for such taxes is denominated in nonfunctional currency. A taxpayer may make an election under this paragraph (b)(1)(ii)(D) for all foreign income taxes, or for only those foreign income taxes that are denominated in nonfunctional currency and are attributable to qualified business units with United States dollar functional currencies. The election must be made by attaching a statement to the taxpayer's timely filed return (including extensions) for the first taxable year to which the election applies. The statement must identify whether the election is made for all foreign taxes or only for foreign taxes attributable to qualified business units with United States dollar functional currencies. Once made, the election shall apply for the taxable year for which made and all subsequent taxable years unless revoked with the consent of the Commissioner. Accrued but unpaid taxes subject to an election under this paragraph (b)(1)(ii)(D) shall be translated into dollars at the exchange rate on the last day of the United States taxable year to which such taxes relate. For taxable years beginning after December 31, 2004, and before November 7, 2007, the rules of Notice

2006–47, 2006–20 IRB 892 (see § 601.601(d)(2)(ii)(*b*)), shall apply.

(E) *Regulated investment companies.* In the case of a regulated investment company (as defined in section 851 and the regulations under that section) which takes into account income on an accrual basis, foreign income taxes paid or accrued with respect to such income shall be translated into dollars using the exchange rate as of the date the income accrues.

(2) *Translation of foreign taxes taken into account when paid.* In the case of a taxpayer that takes foreign income taxes into account when paid, the amount of any foreign tax liability denominated in foreign currency, additional tax liability denominated in foreign currency, or estimated taxes paid in foreign currency shall be translated into dollars using the exchange rate as of the date of payment of such foreign taxes. Foreign taxes withheld in foreign currency shall be translated into dollars using the exchange rate as of the date on which such taxes were withheld.

(3) *Refunds or other reductions of foreign tax liability.* In the case of a taxpayer that takes foreign income taxes into account when accrued, a reduction in the amount of previously-accrued foreign taxes that is attributable to a refund of foreign taxes denominated in foreign currency, a credit allowed in lieu of a refund, the correction of an overaccrual, or an adjustment on account of accrued taxes denominated in foreign currency that were not paid by the date two years after the close of the taxable year to which such taxes relate, shall be translated into dollars using the exchange rate that was used to translate such amount when originally claimed as a credit or added to post-1986 foreign income taxes. In the case of foreign income taxes taken into account when accrued but translated into dollars on the date of payment, see paragraph (d) of this section for required adjustments to reflect a reduction in the amount of previously-accrued foreign taxes that is attributable to a difference in exchange rates between the date of accrual and date of payment. In the case of a taxpayer that takes foreign income taxes into account when paid, a refund or other reduction in the amount of foreign taxes denominated in foreign currency shall be translated into dollars using the exchange rate that was used to translate such amount when originally claimed as a credit. If a refund or other reduction of foreign taxes relates to foreign taxes paid or accrued on more than one date, then the refund or other reduction shall be deemed to be derived from, and shall reduce, the last payment of foreign taxes first, to the extent of that payment. See paragraphs (d)(1) (redetermination of United States tax liability for foreign taxes paid directly by a United States person) and (d)(2)(ii) (method of adjustment of a foreign corporation's pools of post-1986 undistributed earnings and post-1986 foreign income taxes) of this section.

(4) *Allocation of refunds of foreign tax.* Refunds of foreign tax shall be allocated to the same separate category as foreign taxes to which the refunded taxes relate. Refunds are related to foreign taxes of a separate category if the foreign tax that was refunded was imposed with respect to that separate category. See section 904(d) and § 1.904–6 concerning the allocation of taxes to separate categories of income. Earnings and profits of a foreign corporation in the separate category to which the refund relates shall be increased to reflect the foreign tax refund.

(5) *Basis of foreign currency refunded*—(i) *In general.* A recipient of a refund of foreign tax shall determine its basis in the currency refunded under the following rules.

(ii) *United States dollar functional currency.* If the functional currency of the qualified business unit (QBU) (as defined in section 989 and the regulations under that section) that paid the tax and received the refund is the United States dollar or the person receiving the refund is not a QBU, then the recipient's basis in the foreign currency refunded shall be the dollar value of the refund determined under paragraph (b)(3) of this section by using, as appropriate, either the average exchange rate for the taxable year to which such taxes relate or the other exchange rate that was used to translate such amount when originally claimed as a credit or

added to post-1986 foreign income taxes.

(iii) *Nondollar functional currency*. If the functional currency of the QBU receiving the refund is not the United States dollar and is different from the currency in which the foreign tax was paid, then the recipient's basis in the foreign currency refunded shall be equal to the functional currency value of the non-functional currency refund translated into functional currency at the exchange rate between the functional currency and the non-functional currency. Such exchange rate is determined under paragraph (b)(3) of this section by substituting the words ''functional currency'' for the word ''dollar'' and by using, as appropriate, either the average exchange rate for the taxable year to which such taxes relate or the other exchange rate that was used to translate such amount when originally claimed as a credit or added to post-1986 foreign income taxes.

(iv) *Functional currency tax liabilities*. If the functional currency of the QBU receiving the refund is the currency in which the refund was made, then the recipient's basis in the currency received shall be the amount of the functional currency received.

(v) *Foreign currency gain or loss*. For purposes of determining foreign currency gain or loss on the initial payment of accrued foreign tax in a non-functional currency, see section 988. For purposes of determining subsequent foreign currency gain or loss on the disposition of non-functional currency the basis of which is determined under this paragraph (b)(5), see section 988(c)(1)(C).

(c) *Foreign tax redetermination*. For purposes of this section and §1.905–4T, the term *foreign tax redetermination* means a change in the foreign tax liability that may affect a taxpayer's foreign tax credit. A foreign tax redetermination includes: accrued taxes that when paid differ from the amounts added to post-1986 foreign income taxes or claimed as credits by the taxpayer (such as corrections to overaccruals and additional payments); accrued taxes that are not paid before the date two years after the close of the taxable year to which such taxes relate; any tax paid that is refunded in whole or in part; and, for taxes taken into account when accrued but translated into dollars on the date of payment, a difference between the dollar value of the accrued tax and the dollar value of the tax paid attributable to fluctuations in the value of the foreign currency relative to the dollar between the date of accrual and the date of payment.

(d) *Redetermination of United States tax liability*—(1) *Foreign taxes paid directly by a United States person*. If a foreign tax redetermination occurs with respect to foreign tax paid or accrued by or on behalf of a United States taxpayer, then a redetermination of the United States tax liability is required for the taxable year for which the foreign tax was claimed as a credit. See §1.905–4T(b) which requires notification to the IRS of a foreign tax redetermination with respect to which a redetermination of United States liability is required, and see section 905(b) and the regulations under that section which require that a taxpayer substantiate that a foreign tax was paid and provide all necessary information establishing its entitlement to the foreign tax credit. However, a redetermination of United States tax liability is not required (and a taxpayer need not notify the IRS) if the foreign taxes are taken into account when accrued but translated into dollars as of the date of payment, the difference between the dollar value of the accrued tax and the dollar value of the tax paid is attributable to fluctuations in the value of the foreign currency relative to the dollar between the date of accrual and the date of payment, and the amount of the foreign tax redetermination with respect to each foreign country is less than the lesser of ten thousand dollars or two percent of the total dollar amount of the foreign tax initially accrued with respect to that foreign country for the United States taxable year. In such case, an appropriate adjustment shall be made to the taxpayer's United States tax liability in the taxable year during which the foreign tax redetermination occurs.

(2) *Foreign taxes deemed paid under sections 902 or 960*—(i) *Redetermination of United States tax liability not required*. Subject to the special rule of paragraph

(d)(3) of this section, a redetermination of United States tax liability is not required to account for the effect of a redetermination of foreign tax paid or accrued by a foreign corporation on the foreign taxes deemed paid by a United States corporation under section 902 or 960. Instead, appropriate upward or downward adjustments shall be made, in accordance with paragraph (d)(2)(ii) of this section, at the time of the foreign tax redetermination to the foreign corporation's pools of post-1986 undistributed earnings and post-1986 foreign income taxes to reflect the effect of the foreign tax redetermination in calculating foreign taxes deemed paid with respect to distributions and inclusions (and the amount of such distributions and inclusions) that are includible in the United States taxable year in which the foreign tax redetermination occurred and subsequent taxable years. See §1.905–4T(b)(2) for notification requirements where a redetermination of foreign tax paid or accrued by a foreign corporation affects the computation of foreign taxes deemed paid under section 902 or 960, and the taxpayer is required to adjust the foreign corporation's pools of post-1986 undistributed earnings and post-1986 foreign income taxes under this paragraph (d)(2).

(ii) *Adjustments to the pools of post-1986 undistributed earnings and post-1986 foreign income taxes*—(A) *Reduction in foreign tax paid or accrued.* A foreign corporation's pool of post-1986 foreign income taxes in the appropriate separate category shall be reduced by the United States dollar amount of a foreign tax refund or other reduction in the amount of foreign tax paid or accrued, translated into United States dollars as provided in paragraph (b)(3) of this section. A foreign corporation's pool of post-1986 undistributed earnings in the appropriate separate category shall be increased by the functional currency amount of the foreign tax refund or other reduction in the amount of foreign tax paid or accrued. The allocation of the refund or other adjustment to the appropriate separate categories shall be made in accordance with paragraph (b)(4) of this section and §1.904–6. If a foreign corporation receives a refund of foreign tax in a currency other than its functional currency, that refund shall be translated into its functional currency, for purposes of computing the increase to its pool of post-1986 undistributed earnings, at the exchange rate between the functional currency and the non-functional currency, as determined under paragraph (b)(3) of this section, by substituting the words ''functional currency'' for the word ''dollar'' and by using the same average or spot rate exchange rate convention that applies for purposes of translating such foreign taxes into United States dollars.

(B) *Additional foreign tax paid or accrued.* A foreign corporation's pool of post-1986 foreign income taxes in the appropriate separate category shall be increased by the United States dollar amount of the additional foreign tax paid or accrued, translated in accordance with the rules of paragraphs (b)(1) and (b)(2) of this section. A foreign corporation's pool of post-1986 undistributed earnings in the appropriate separate category shall be decreased by the functional currency amount of the additional foreign tax paid or accrued. The allocation of the additional amount of foreign tax among the separate categories shall be made in accordance with §1.904–6. If a foreign corporation pays or accrues foreign tax in a currency other than its functional currency, that tax shall be translated into its functional currency, for purposes of computing the decrease to its pool of post-1986 undistributed earnings, at the exchange rate between the functional currency and the non-functional currency, as determined under paragraph (b)(3) of this section, by substituting the words ''functional currency'' for the word ''dollar'' and by using the same average or spot rate exchange rate convention that applies for purposes of translating such foreign taxes into United States dollars.

(C) *Refunds of foreign taxes of lower tier foreign corporations that cause deficits in foreign tax pools.* If a lower tier foreign corporation receives a refund of foreign tax after making a distribution to an upper tier foreign corporation and the refund would have the effect of reducing below zero the lower tier corporation's pool of foreign taxes in any separate category, then both the lower tier and upper tier corporations shall

adjust the appropriate pool of foreign taxes to reflect that refund. The upper tier foreign corporation shall adjust its pool of foreign taxes by the difference between the United States dollar amount of foreign tax deemed paid by the upper tier foreign corporation prior to the refund and the United States dollar amount of foreign tax recomputed as if the refund occurred prior to the distribution. The upper tier foreign corporation shall not make any adjustment to its earnings and profits because foreign taxes deemed paid by the upper tier corporation are not included in the upper tier corporation's earnings and profits. The lower tier foreign corporation shall adjust its pool of foreign taxes by the difference between the United States dollar amount of the refund and the United States dollar amount of the adjustment to the upper tier foreign corporation's pool of foreign taxes. The earnings and profits of the lower tier foreign corporation shall be adjusted to reflect the full amount of the refund. The provisions of this paragraph (d)(2)(ii)(C) do not apply to distributions or inclusions to a United States person. See paragraph (d)(3)(iv) of this section for rules relating to actual or deemed distributions made to a United States person.

(D) *Examples*. The following examples illustrate the application of this paragraph (d)(2):

Example 1. Controlled foreign corporation (CFC) is a wholly-owned subsidiary of its domestic parent, P. Both CFC and P are calendar year taxpayers. CFC has a functional currency, the u, other than the dollar and its pool of post-1986 undistributed earnings is maintained in that currency. CFC and P use the average exchange rate to translate foreign taxes. In 2008, CFC accrued and paid 100u of foreign income taxes with respect to non-subpart F income. The average exchange rate for 2008 was $1:1u. In 2009, CFC received a refund of 50u of foreign taxes with respect to its non-subpart F income in 2008. CFC made no distributions to P in 2008. In accordance with paragraph (d)(2)(ii)(A) of this section and subject to paragraph (d)(3) of this section, in 2009 CFC's pool of post-1986 foreign income taxes must be reduced by $50 (because the refund must be translated into dollars using the exchange rate that was used to translate such amount when added to CFC's post-1986 foreign income taxes, that is, $1:1u, the average exchange rate for 2008) and the CFC's pool of post-1986 undistributed earnings must be increased by 50u (because the post-1986 undistributed earnings must be increased by the functional currency amount of the refund received). An income adjustment reflecting foreign currency gain or loss under section 988 with respect to the refund of foreign taxes received by CFC is not required because the foreign taxes are denominated and paid in CFC's functional currency.

Example 2. The facts are the same as in *Example 1,* except that in 2008, CFC had general category post-1986 undistributed earnings attributable to non-subpart F income of 200u (net of foreign taxes), and CFC accrued and paid 160u in foreign income taxes with respect to those earnings. The average exchange rate for 2008 was $1:1u. Also in 2008, CFC made a distribution to P of 50u, and P was deemed to have paid $40 of foreign taxes with respect to that distribution (50u/200u × $160). In 2009, CFC received a refund of foreign taxes of 5u with respect to its nonsubpart F income in 2008. Also in 2009, CFC made a distribution to P of 50u. CFC had no income and paid no foreign taxes in 2009. In accordance with paragraph (d)(2)(ii) of this section, CFC's pool of general category post-1986 foreign income taxes is reduced in 2009 by $5 to $115 (because the refund must be translated into dollars using the exchange rate that was used to translate such amount when added to CFC's post-1986 foreign income taxes, that is, $1:1u, the average exchange rate for 2008), and CFC's pool of general category post-1986 undistributed earnings must be increased in 2009 by 5u to 155u (because the post-1986 undistributed earnings must be increased by the functional currency amount of the refund received). (An income adjustment reflecting foreign currency gain or loss under section 988 with respect to the refund of foreign taxes received by CFC is not required because the foreign taxes are denominated and paid in CFC's functional currency.) A redetermination of P's deemed paid credit and U.S. tax for 2008 is not required, because the 5u refund, if taken into account in 2008, would have reduced P's deemed paid taxes by less than 10% (50u/205u × $155 = $37.80). See paragraph (d)(3)(ii) of this section. P is deemed to pay $37.10 of foreign taxes with respect to the distribution in 2009 of 50u (50u/155u × $115).

Example 3. (i) CFC1 is a foreign corporation that is wholly-owned by P, a domestic corporation. CFC2 is a foreign corporation that is wholly-owned by CFC1. The functional currency of CFC1 and CFC2 is the u, and the pools of post-1986 undistributed earnings of CFC1 and CFC2 are maintained in that currency. CFC1, CFC2, and P use the average exchange rate to translate foreign income taxes. In 2008, CFC2 had post-1986 undistributed earnings attributable to non-subpart F income of 100u (net of foreign taxes) and paid 100u in foreign income taxes with respect to those earnings. The average exchange rate for 2008 was $1:1u. CFC1 had no income and

no earnings and profits other than those resulting from distributions from CFC2, as provided in either Situation 1 or Situation 2. CFC1 paid no foreign taxes.

(ii) *Situation 1*. In 2009, CFC2 received a refund of foreign taxes of 25u with respect to its 2008 taxable year. As of the close of 2009, CFC2 had 125u of post-1986 undistributed earnings (100u + 25u) and $75 of post-1986 foreign income taxes ($100 – $25). In 2010, CFC2 made a distribution to CFC1 of 50u. CFC1 was deemed to have paid $30 of foreign taxes with respect to that distribution (50u/125u × $75). (An income adjustment reflecting foreign currency gain or loss under section 988 with respect to the refund of foreign taxes received by CFC1 is not required because the foreign taxes are denominated and paid in CFC1's functional currency.) At the end of 2010, CFC2 had 75u of post-1986 undistributed earnings (125u – 50u) and $45 of post-1986 foreign income taxes ($75 – $30).

(iii) *Situation 2*. The facts are the same as in *Example 3(ii), Situation 1*, except that CFC2 made a distribution of 50u in 2009 and received a refund of 75u of foreign tax in 2010. In 2009, the amount of foreign taxes deemed paid by CFC1 is $50 (50u/100u × $100). In accordance with paragraph (d)(2)(ii)(C) of this section, the pools of post-1986 foreign income taxes of CFC1, as well as CFC2, must be adjusted in 2010, because the 2010 refund would otherwise have the effect of reducing below zero CFC2's pool of post-1986 foreign income taxes. Under paragraph (d)(3)(iv) of this section, the pools would have to be adjusted in 2009, and a redetermination of P's United States tax liability would be required, if P had received or accrued a distribution or inclusion from CFC1 or CFC2 in 2009 and computed an amount of foreign taxes deemed paid. CFC1's pool of post-1986 foreign income taxes must be reduced in 2010 by $42.86, determined as follows: $50 (foreign taxes deemed paid on the distribution from CFC2) minus $7.14 (the foreign taxes that would have been deemed paid had the refund occurred prior to the distribution (50u/175u × $25)). CFC2's pool of foreign taxes must be reduced in 2010 by $32.14, determined as follows: $75 (75u refund translated into dollars using the exchange rate that was used to translate such amount when originally added to post-1986 foreign income taxes, that is, $1:1u, the average exchange rate for 2008) minus $42.86 (the adjustment to CFC1's pool of post-1986 foreign income taxes). (An income adjustment reflecting foreign currency gain or loss under section 988 with respect to the refund of foreign taxes received by CFC1 is not required because the foreign taxes are denominated and paid in CFC1's functional currency.) The following reflects the pools of post-1986 undistributed earnings and post-1986 foreign income taxes of CFC1 and CFC2.

	Post-1986 earnings (u)	Foreign taxes ($)
CFC2:		
2008	100	100
2009	100 – 50 = 50	100 – 50 = 50
2010	50 + 75 = 125	50 – 32.14 = 17.86
CFC1:		
2009	50	50
2010	50	50 – 42.86 = 7.14

(3) *Exceptions*. The provisions of paragraph (d)(2) of this section shall not apply and a redetermination of United States tax liability is required to account for the effect of a redetermination of foreign tax on foreign taxes deemed paid by a United States corporation under section 902 or section 960 to the extent provided in this paragraph (d)(3).

(i) *Hyperinflationary currencies*. A redetermination of United States tax liability is required if the foreign tax liability is in a hyperinflationary currency. The term ''hyperinflationary currency'' means the currency of a country in which there is cumulative inflation during the base period of at least 100% as determined by reference to the consumer price index of the country listed in the monthly issues of International Financial Statistics, or a successor publication, of the International Monetary Fund. ''Base period'' means, with respect to any taxable year, the thirty-six calendar months immediately preceding the last day of such taxable year (see §1.985–2T(b)(2)).

(ii) *Deemed paid foreign tax adjustment of ten percent or more*. A redetermination of United States tax liability is required if a foreign tax redetermination occurs with respect to foreign taxes paid by a foreign corporation and such foreign tax redetermination, if taken into account in the taxable year of the foreign corporation to which the foreign tax redetermination relates, has the effect of reducing by ten percent or

more the domestic corporate shareholder's foreign taxes deemed paid under section 902 or 960 with respect to a distribution or inclusion from the foreign corporation in any taxable year of the domestic corporate shareholder. If a redetermination of United States tax is required under the preceding sentence for any taxable year, a redetermination of United States tax is also required for all subsequent taxable years in which the domestic corporate shareholder received or accrued a distribution or inclusion from the foreign corporation.

(iii) *Example*. The following example illustrates the application of paragraph (d)(3)(ii) of this section:

Example. (i) *Facts*. Controlled foreign corporation (CFC) is a wholly-owned subsidiary of its domestic parent, P. Both CFC and P use the calendar year as their taxable year. CFC has a functional currency, the u, other than the dollar, and its pool of post-1986 undistributed earnings is maintained in that currency. CFC and P use the average exchange rate to translate foreign income taxes. As of January 1, 2008, CFC had 500u of general category post-1986 undistributed earnings and $200 of general category post-1986 foreign income taxes. In 2008, when the average exchange rate for the year was $1:1u, CFC earned general category income of 600u, accrued 100u of foreign income tax with respect to that income, and made a distribution to P of 100u, 10% of CFC's post-1986 undistributed earnings of 1,000u. P was deemed to have paid $30 of foreign income taxes in 2008 with respect to that distribution (100u/1,000u × $300). In 2009, CFC paid its actual foreign tax liability for 2008 of 80u. Also in 2009, for which the average exchange rate was $1:1.5u, CFC earned 500u of general category income, accrued 150u of tax with respect to that income, and distributed 100u to P. In 2010, CFC incurred a general category loss of (500u) and accrued no foreign tax. The loss was carried back to 2008 for foreign tax purposes, and CFC received a refund in 2011 of all 80u of foreign taxes paid for its 2008 taxable year.

(ii) *Result in 2009*. If the 20u overaccrual of tax for 2008 were taken into account in 2008, CFC's general category post-1986 undistributed earnings would be 1,020u, CFC's general category post-1986 foreign income taxes would be $280, and P would be deemed to pay $27.45 of tax with respect to the 2008 distribution of 100u (100u/1020u × $280 = $27.45). Because $2.55 is less than 10% of the $30 of foreign taxes deemed paid as originally calculated in 2008, P is not required to redetermine its deemed paid credit and U.S. tax liability for 2008 in 2009. Instead, CFC's general category post-1986 foreign income taxes are reduced by $20 in 2009 (because the overaccrual for 2008 is translated into dollars using the exchange rate that was used to translate such amount when originally added to post-1986 foreign income taxes, that is, $1:1u, the average exchange rate for 2008), and the corresponding pool of general category post-1986 undistributed earnings is increased by 20u in 2009 (because the post-1986 undistributed earnings pool is increased by the functional currency amount of the overaccrual). CFC's general category post-1986 undistributed earnings are also increased in 2009 to 1270u by the 350u earned in 2009 (900u + 20u + 350u = 1270u), and CFC's general category post-1986 foreign income taxes are increased by $100 to $350 ($270 − $20 + $100). P is deemed to pay $27.56 of foreign income taxes in 2009 with respect to the 100u distribution from CFC in that year (100u/1270u × $350).

(iii) *Result in 2011*. If the 80u refund of tax for 2008 were taken into account in 2008, CFC's general category post-1986 undistributed earnings would be 1,100u, CFC's general category post-1986 foreign income taxes would be $200, and P would be deemed to pay $18.18 of tax with respect to the 2008 distribution of 100u (100u/1,100u × $200 = $18.18). Because $11.82 is more than 10% of the $30 of foreign taxes deemed paid as originally calculated in 2008, under paragraph (d)(3)(ii) of this section, P is required to redetermine its deemed paid credit and U.S. tax liability for 2008 and 2009 in 2011. As determined in 2011, CFC's post-1986 undistributed earnings for 2009 are 1350u (1,100u as revised for 2008, less 100u distributed in 2008, plus 350u earned in 2009), and its post-1986 foreign income taxes for 2009 are $281.82 ($200 as revised for 2008, less $18.18 deemed paid in 2008, plus $100 accrued for 2009). As redetermined in 2011, P's deemed paid credit with respect to the 100u distribution from CFC in 2009 is $20.88 (100u/1350u × $281.82).

(iv) *Deficit in foreign tax pool*. A redetermination of United States tax liability is required if a foreign tax redetermination occurs with respect to foreign taxes deemed paid with respect to a subpart F inclusion or an actual distribution which has the effect of reducing below zero the distributing foreign corporation's pool of foreign taxes in any separate category. Whether a foreign corporation's pool of foreign taxes is reduced below zero shall be determined at the close of the taxable year of the foreign corporation in which the foreign tax redetermination occurred. In no case shall taxes paid or accrued with respect to one separate category

be applied to offset a negative balance in any other separate category.

(v) *Example*. The following example illustrates the application of paragraph (d)(3)(iv) of this section:

Example. Controlled foreign corporation (CFC) is a wholly-owned subsidiary of its domestic parent, P. Both CFC and P are calendar year taxpayers. CFC has a functional currency, the u, other than the dollar, and its pool of post-1986 undistributed earnings is maintained in that currency. CFC and P use the average exchange rate to translate foreign taxes. The average exchange rate for both 2008 and 2009 was $1:1u. In 2008, CFC earned 200u of general category income, accrued and paid 100u of foreign taxes with respect to that income, and made a distribution to P of 50u, half of CFC's post-1986 undistributed earnings of 100u. P is deemed to have paid $50 of foreign taxes with respect to that distribution (50u/100u × $100). In 2009, CFC received a refund of all 100u of foreign taxes related to the general category income for 2008. In 2009, CFC earned an additional 290u of income, 200u of which was passive category income and 90u of which was general category income, and accrued and paid 95u of foreign tax, 40u of which was with respect to the passive category income and 45u of which was with respect to the general category income. In accordance with paragraph (d)(3)(iv) of this section, P is required to redetermine its United States tax liability for 2008 to account for the foreign tax redetermination occurring in 2009 because, if an adjustment to CFC's pool of post-1986 foreign income taxes in the general category were made, the pool would be ($5). A deficit is not permitted to be carried in CFC's pool of post-1986 foreign income taxes in any separate category.

(vi) *Reduction of corporate level tax on distribution of earnings and profits*. If a United States shareholder of a controlled foreign corporation receives a distribution out of previously taxed earnings and profits and a foreign country has imposed tax on the income of the controlled foreign corporation, which tax is reduced on distribution of the earnings and profits of the corporation, then the United States shareholder shall redetermine its United States tax liability for the year or years affected.

(e) *Foreign tax imposed on foreign refund*. If the redetermination of foreign tax for a taxable year or years is occasioned by the refund to the taxpayer of taxes paid to a foreign country or possession of the United States and the foreign country or possession imposed tax on the refund, then the amount of the refund shall be considered to be reduced by the amount of any tax described in section 901 imposed by the foreign country or possession of the United States with respect to such refund. In such case, no other credit under section 901, and no deduction under section 164, shall be allowed for any taxable year with respect to such tax imposed on such refund.

(f) *Expiration date*. The applicability of this section expires on or before November 5, 2010.

[T.D. 8210, 53 FR 23613, June 23, 1988, as amended by T.D. 9362, 72 FR 62780, Nov. 7, 2007; 72 FR 71787, Dec. 19, 2007]

§ 1.905–4T Notification of foreign tax redetermination (temporary).

(a) *Application of this section*. The rules of this section apply if, as a result of a foreign tax redetermination (as defined in § 1.905–3T(c)), a redetermination of United States tax liability is required under section 905(c) and § 1.905–3T(d).

(b) *Time and manner of notification*—(1) *Redetermination of United States tax liability*—(i) *In general*. Except as provided in paragraphs (b)(1)(iv), (v), and (b)(3) of this section, any taxpayer for which a redetermination of United States tax liability is required must notify the Internal Revenue Service (IRS) of the foreign tax redetermination by filing an amended return, Form 1118 (Foreign Tax Credit—Corporations) or Form 1116 (Foreign Tax Credit), and the statement required under paragraph (c) of this section for the taxable year with respect to which a redetermination of United States tax liability is required. Such notification must be filed within the time prescribed by this paragraph (b) and contain the information described in paragraph (c) of this section. Where a foreign tax redetermination requires an individual to redetermine the individual's United States tax liability, and as a result of such foreign tax redetermination the amount of creditable taxes paid or accrued by such individual during the taxable year does not exceed the applicable dollar limitation in section 904(k), the individual shall not be required to file Form 1116 with

the amended return for such taxable year if the individual satisfies the requirements of section 904(k).

(ii) *Reduction in amount of foreign tax liability*. Except as provided in paragraphs (b)(1)(iv), (v), and (b)(3) of this section, for each taxable year of the taxpayer with respect to which a redetermination of United States tax liability is required by reason of a foreign tax redetermination that reduces the amount of foreign taxes paid or accrued, or included in the computation of foreign taxes deemed paid, the taxpayer must file a separate notification for each such taxable year by the due date (with extensions) of the original return for the taxpayer's taxable year in which the foreign tax redetermination occurred.

(iii) *Increase in amount of foreign tax liability*. Except as provided in paragraphs (b)(1)(iv), (v), and (b)(3) of this section, for each taxable year of the taxpayer with respect to which a redetermination of United States tax liability is required by reason of a foreign tax redetermination that increases the amount of foreign taxes paid or accrued, or included in the computation of foreign taxes deemed paid, the taxpayer must notify the Internal Revenue Service within the period provided by section 6511(d)(3)(A). Filing of such notification within the prescribed period shall constitute a claim for refund of United States tax.

(iv) *Multiple redeterminations of United States tax liability for same taxable year*. Where more than one foreign tax redetermination requires a redetermination of United States tax liability for the same taxable year of the taxpayer and those redeterminations occur within two consecutive taxable years of the taxpayer, the taxpayer may file for such taxable year one amended return, Form 1118 or 1116, and the statement required under paragraph (c) of this section that reflect all such foreign tax redeterminations. If the taxpayer chooses to file one notification for such redeterminations, the taxpayer must file such notification by the due date (with extensions) of the original return for the taxpayer's taxable year in which the first foreign tax redetermination that reduces foreign tax liability occurred. Where a foreign tax redetermination with respect to the taxable year for which a redetermination of United States tax liability is required occurs after the date for providing such notification, more than one amended return may be required with respect to that taxable year.

(v) *Carryback and carryover of unused foreign tax*. Where a foreign tax redetermination requires a redetermination of United States tax liability that would otherwise result in an additional amount of United States tax due, but such amount is eliminated as a result of a carryback or carryover of an unused foreign tax under section 904(c), the taxpayer may, in lieu of applying the rules of paragraphs (b)(1)(i) and (ii) of this section, notify the IRS of such redetermination by attaching a statement to the original return for the taxpayer's taxable year in which the foreign tax redetermination occurs. Such statement must be filed by the due date (with extensions) of the original return for the taxpayer's taxable year in which the foreign tax redetermination occurred and contain the information described in § 1.904–2(f).

(vi) *Example*. The following example illustrates the application of this paragraph (b)(1):

Example. (i) X, a domestic corporation, is an accrual basis taxpayer and uses the calendar year as its United States taxable year. X conducts business through a branch in Country M, the currency of which is the m, and also conducts business through a branch in Country N, the currency of which is the n. X uses the average exchange rate to translate foreign income taxes. Assume that X is able to claim a credit under section 901 for all foreign taxes paid or accrued.

(ii) In 2008, X accrued and paid 100m of Country M taxes with respect to 400m of foreign source general category income. The average exchange rate for 2008 was $1:1m. Also in 2008, X accrued and paid 50n of Country N taxes with respect to 150n of foreign source general category income. The average exchange rate for 2008 was $1:1n. X claimed a foreign tax credit of $150 ($100 (100m at $1:1m) + $50 (50n at $1:1n)) with respect to its foreign source general category income on its United States tax return for 2008.

(iii) In 2009, X accrued and paid 100n of Country N taxes with respect to 300n of foreign source general category income. The average exchange rate for 2009 was $1.50:1n. X claimed a foreign tax credit of $150 (100n at $1.5:1n) with respect to its foreign source

general category income on its United States tax return for 2009.

(iv) On June 15, 2012, when the spot exchange rate was $1.40:1n, X received a refund of 10n from Country N, and, on March 15, 2013, when the spot exchange rate was $1.20:1m, X was assessed by and paid Country M an additional 20m of tax. Both payments were with respect to X's foreign source general category income in 2008. On May 15, 2013, when the spot exchange rate was $1.45:1n, X received a refund of 5n from Country N with respect to its foreign source general category income in 2009.

(v) X must redetermine its United States tax liability for both 2008 and 2009. With respect to 2008, X must notify the IRS of the June 15, 2012, refund of 10n from Country N that reduced X's foreign tax liability by filing an amended return, Form 1118, and the statement required in paragraph (c) of this section for 2008 by the due date of the original return (with extensions) for 2012. The amended return and Form 1118 must reduce the amount of foreign taxes claimed as a credit under section 901 by $10 (10n refund translated at the average exchange rate for 2008, or $1:1n (see § 1.905–3T(b)(3)). X will recognize foreign currency gain or loss under section 988 in or after 2012 on the conversion of the 10n refund into dollars. With respect to the March 15, 2013, additional assessment of 20m by Country M, X must notify the IRS within the time period provided by section 6511(d)(3)(A), increasing the foreign taxes available as a credit by $24 (20m translated at the exchange rate on the date of payment, or $1.20:1m). See sections 986(a)(1)(B)(i) and 986(a)(2)(A) and § 1.905–3T(b)(1)(ii)(A). X may so notify the IRS by filing a second amended return, Form 1118, and the statement required in paragraph (c) of this section for 2008, within the time period provided by section 6511(d)(3)(A). Alternatively, when X redetermines its United States tax liability for 2008 to take into account the 10n refund from Country N which occurred in 2012, X may also take into account the 20m additional assessment by Country M which occurred on March 15, 2013. See § 1.905–4T(b)(1)(iv). Where X reflects both foreign tax redeterminations on the same amended return, Form 1118, and in the statement required in paragraph (c) of this section for 2008, the amount of X's foreign taxes available as a credit would be:

(A) Reduced by $10 (10n refund translated at $1:1n) and

(B) Increased by $24 (20m additional assessment translated at the exchange rate on the date of payment, March 15, 2013, or $1.20:1m). The foreign taxes available as a credit therefore would be increased by $14 ($24 (additional assessment) − $10 (refund)). The due date of the 2008 amended return, Form 1118, and the statement required in paragraph (c) of this section reflecting foreign tax redeterminations in both years would be the due date (with extensions) of X's original return for 2012.

(vi) With respect to 2009, X must notify the IRS by filing an amended return, Form 1118, and the statement required in paragraph (c) of this section for 2009 that is separate from that filed for 2008. The amended return, Form 1118, and the statement required in paragraph (c) of this section for 2009 must be filed by the due date (with extensions) of X's original return for 2013. The amended return and Form 1118 must reduce the amount of foreign taxes claimed as a credit under section 901 by $7.50 (5n refund translated at the average exchange rate for 2009, or $1.50:1n). X will recognize foreign currency gain or loss under section 988 in or after 2013 on the conversion of the 5n refund into dollars.

(2) *Pooling adjustment in lieu of redetermination of United States tax liability.* Where a redetermination of foreign tax paid or accrued by a foreign corporation affects the computation of foreign taxes deemed paid under section 902 or 960, and the taxpayer is required to adjust the foreign corporation's pools of post-1986 undistributed earnings and post-1986 foreign income taxes under § 1.905–3T(d)(2), the taxpayer is required to notify the IRS of such redetermination by reflecting the adjustments to the foreign corporation's pools of post-1986 undistributed earnings and post-1986 foreign income taxes on a Form 1118 for the taxpayer's first taxable year with respect to which the redetermination affects the computation of foreign taxes deemed paid. Such Form 1118 must be filed by the due date (with extensions) of the original return for such taxable year. In the case of multiple redeterminations that affect the computation of foreign taxes deemed paid for the same taxable year and that are required to be reported under this paragraph (b)(2), a taxpayer may file one notification for all such redeterminations in lieu of filing a separate notification for each such redetermination. See section 905(b) and the regulations under that section which require that a taxpayer substantiate that a foreign tax was paid and provide all necessary information establishing its entitlement to the foreign tax credit.

(3) *Taxpayers under the jurisdiction of the Large and Mid-Size Business Division.* The rules of this paragraph (b)(3) apply where a redetermination of United States tax liability is required by reason of a foreign tax redetermination

that results in a reduction in the amount of foreign taxes paid or accrued, or included in the computation of foreign taxes deemed paid, and such foreign tax redetermination occurs while a taxpayer is under the jurisdiction of the Large and Mid-Size Business Division (or similar program). The taxpayer must, in lieu of applying the rules of paragraphs (b)(1)(i) and (ii) of this section (requiring the filing of an amended return, Form 1118, and a statement described in paragraph (c) of this section by the due date (with extensions) of the original return for the taxpayer's taxable year in which the foreign tax redetermination occurred), notify the IRS of such redetermination by providing to the examiner the statement described in paragraph (c) of this section during an examination of the return for the taxable year for which a redetermination of United States tax liability is required by reason of such foreign tax redetermination. The taxpayer must provide the statement to the examiner no later than 120 days after the latest of the date the foreign tax redetermination occurs, the opening conference of the examination, or the hand-delivery or postmark date of the opening letter concerning the examination. If, however, the foreign tax redetermination occurs more than 180 days after the latest of the opening conference or the hand-delivery or postmark date of the opening letter, the taxpayer may, in lieu of applying the rules of paragraphs (b)(1)(i) and (ii) of this section, provide the statement to the examiner within 120 days after the date the foreign tax redetermination occurs, and the IRS, in its discretion, may accept such statement or require the taxpayer to comply with the rules of paragraphs (b)(1)(i) and (ii) of this section. A taxpayer subject to the rules of this paragraph (b)(3) must satisfy the rules of this paragraph (b)(3) (in lieu of the rules of paragraphs (b)(1)(i) and (ii) of this section) in order not to be subject to the penalty relating to the failure to file notice of a foreign tax redetermination under section 6689 and the regulations under that section. This paragraph (b)(3) shall not apply where the due date specified in paragraph (b)(1)(ii) of this section for providing notice of the foreign tax redetermination precedes the latest of the opening conference or the hand-delivery or postmark date of the opening letter concerning an examination of the return for the taxable year for which a redetermination of United States tax liability is required by reason of such foreign tax redetermination. In addition, any statement that would otherwise be required to be provided under this paragraph (b)(3) on or before May 5, 2008 will be considered timely if provided on or before May 5, 2008.

(4) *Example*. The following example illustrates the application of paragraph (b)(3) of this section:

Example. X, a taxpayer under the jurisdiction of the Large and Mid-Size Business Division, uses the calendar year as its United States taxable year. On October 15, 2009, X receives a refund of foreign tax that constitutes a foreign tax redetermination that necessitates a redetermination of United States tax liability for X's 2008 taxable year. Under paragraph (b)(1)(ii) of this section, X is required to notify the IRS of the foreign tax redetermination by filing an amended return, Form 1118, and the statement required in paragraph (c) of this section for its 2008 taxable year by September 15, 2010 (the due date (with extensions) of the original return for X's 2009 taxable year). On December 15, 2010, the IRS hand delivers an opening letter concerning the examination of the return for X's 2008 taxable year, and the opening conference for such examination is scheduled for January 15, 2011. Because the date for notifying the IRS of the foreign tax redetermination under paragraph (b)(1)(ii) of this section precedes the date of the opening conference concerning the examination of the return for X's 2008 taxable year, paragraph (b)(3) of this section does not apply, and X must notify the IRS of the foreign tax redetermination by filing a amended return, Form 1118, and the statement required in paragraph (c) of this section for the 2008 taxable year by September 15, 2010.

(c) *Notification contents*—(1) *In general*. In addition to satisfying the requirements of paragraph (b) of this section, the taxpayer must furnish a statement that contains information sufficient for the IRS to redetermine the taxpayer's United States tax liability where such a redetermination is required under section 905(c), and to verify adjustments to the pools of post-1986 undistributed earnings and post-1986 foreign income taxes where such adjustments are required under § 1.905–

3T(d)(2). The information must be in a form that enables the IRS to verify and compare the original computations with respect to a claimed foreign tax credit, the revised computations resulting from the foreign tax redetermination, and the net changes resulting therefrom. The statement must include the taxpayer's name, address, identifying number, and the taxable year or years of the taxpayer that are affected by the foreign tax redetermination. In addition, the taxpayer must provide the information described in paragraph (c)(2) or (c)(3) of this section, as appropriate. If the statement is submitted to the IRS under paragraph (b)(3) of this section, which provides requirements with respect to reporting by taxpayers under the jurisdiction of the Large and Mid-Size Business Division, the statement must also include the following declaration signed by a person authorized to sign the return of the taxpayer: ''Under penalties of perjury, I declare that I have examined this written statement, and to the best of my knowledge and belief, this written statement is true, correct, and complete.''

(2) *Foreign taxes paid or accrued.* Where a redetermination of United States tax liability is required by reason of a foreign tax redetermination as defined in §1.905–3T(c), in addition to the information described in paragraph (c)(1) of this section, the taxpayer must provide the following: the date or dates the foreign taxes were accrued, if applicable; the date or dates the foreign taxes were paid; the amount of foreign taxes paid or accrued on each date (in foreign currency) and the exchange rate used to translate each such amount, as provided in §1.905–3T(b)(1) or (b)(2); and information sufficient to determine any interest due from or owing to the taxpayer, including the amount of any interest paid by the foreign government to the taxpayer and the dates received. In addition, in the case of any foreign tax that is refunded in whole or in part, the taxpayer must provide the date of each such refund; the amount of such refund (in foreign currency); and the exchange rate that was used to translate such amount when originally claimed as a credit (as provided in §1.905–3T(b)(3)) and the exchange rate for the date the refund was received (for purposes of computing foreign currency gain or loss under section 988). In addition, in the case of any foreign taxes that were not paid before the date two years after the close of the taxable year to which such taxes relate, the taxpayer must provide the amount of such taxes in foreign currency, and the exchange rate that was used to translate such amount when originally added to post-1986 foreign income taxes or claimed as a credit. Where a redetermination of United States tax liability results in an amount of additional tax due, but the carryback or carryover of an unused foreign tax under section 904(c) only partially eliminates such amount, the taxpayer must also provide the information required in §1.904–2(f).

(3) *Foreign taxes deemed paid.* Where a redetermination of United States tax liability is required under §1.905–3T(d)(3) to account for the effect of a redetermination of foreign tax paid or accrued by a foreign corporation on foreign taxes deemed paid under section 902 or 960, in addition to the information described in paragraphs (c)(1) and (c)(2) of this section, the taxpayer must provide the balances of the pools of post-1986 undistributed earnings and post-1986 foreign income taxes before and after adjusting the pools in accordance with the rules of §1.905–3T(d)(2), the dates and amounts of any dividend distributions or other inclusions made out of earnings and profits for the affected year or years, and the amount of earnings and profits from which such dividends were paid for the affected year or years.

(d) *Payment or refund of United States tax.* The amount of tax, if any, due upon a redetermination of United States tax liability shall be paid by the taxpayer after notice and demand has been made by the IRS. Subchapter B of chapter 63 of the Internal Revenue Code (relating to deficiency procedures) shall not apply with respect to the assessment of the amount due upon such redetermination. In accordance with sections 905(c) and 6501(c)(5), the amount of additional tax due shall be assessed and collected without regard to the provisions of section 6501(a) (relating to limitations on assessment

and collection). The amount of tax, if any, shown by a redetermination of United States tax liability to have been overpaid shall be credited or refunded to the taxpayer in accordance with the provisions of section 6511(d)(3)(A) and § 301.6511(d)–3 of this chapter.

(e) *Interest and penalties*—(1) *In general*. If a redetermination of United States tax liability is required by reason of a foreign tax redetermination, interest shall be computed on the underpayment or overpayment in accordance with sections 6601 and 6611 and the regulations under these sections. No interest shall be assessed or collected on any underpayment resulting from a refund of foreign tax for any period before the receipt of the refund, except to the extent interest was paid by the foreign country or possession of the United States on the refund for the period. In no case, however, shall interest assessed and collected pursuant to the preceding sentence for any period before receipt of the foreign tax refund exceed the amount that otherwise would have been assessed and collected under section 6601 and the regulations under this section for that period. Interest shall be assessed from the time the taxpayer (or the foreign corporation of which the taxpayer is a shareholder) receives a refund until the taxpayer pays the additional tax due the United States.

(2) *Adjustments to pools of foreign taxes*. No underpayment or overpayment of United States tax liability results from a redetermination of foreign tax unless a redetermination of United States tax liability is required. Consequently, no interest shall be paid by or to a taxpayer as a result of adjustments to a foreign corporation's pools of post-1986 undistributed earnings and post-1986 foreign income taxes made in accordance with § 1.905–3T(d)(2).

(3) *Imposition of penalty*. Failure to comply with the provisions of this section shall subject the taxpayer to the penalty provisions of section 6689 and the regulations under that section.

(f) *Effective/applicability date*—(1) *In general*. This section applies to foreign tax redeterminations (defined in § 1.905–3T(c)) occurring in taxable years of United States taxpayers beginning on or after November 7, 2007, where the foreign tax redetermination affects the amount of foreign taxes paid or accrued by a United States taxpayer. Where the redetermination of foreign tax paid or accrued by a foreign corporation affects the computation of foreign taxes deemed paid under section 902 or 960 with respect to pre-1987 accumulated profits or post-1986 undistributed earnings of the foreign corporation, this section applies to foreign tax redeterminations occurring in a taxable year of the foreign corporation which ends with or within a taxable year of its domestic corporate shareholder beginning on or after November 7, 2007. In no case, however, shall this paragraph (f)(1) operate to extend the statute of limitations provided by section 6511(d)(3)(A).

(2) *Foreign tax redeterminations occurring in taxable years beginning before November 7, 2007*—(i) *Scope*. This paragraph (f)(2) applies to any foreign tax redetermination (as defined in § 1.905–3T(c)) which occurred in any of the three taxable years of a United States taxpayer immediately preceding the taxpayer's first taxable year beginning on or after November 7, 2007; reduced the amount of foreign taxes paid or accrued by the taxpayer; and requires a redetermination of United States tax liability for any taxable year. This paragraph (f)(2) also applies to any redetermination of foreign tax paid or accrued by a foreign corporation which occurred in a taxable year of the foreign corporation which ends with or within any of the three taxable years of a domestic corporate shareholder immediately preceding such shareholder's first taxable year beginning on or after November 7, 2007; reduced foreign taxes included in the computation of foreign taxes deemed paid by such shareholder under section 902 or 960; and requires a redetermination of United States tax liability under § 1.905–3T(d)(3) for any taxable year. For corresponding rules applicable to foreign tax redeterminations occurring in taxable years beginning before the third taxable year immediately preceding the taxable year beginning on or after November 7, 2007, see 26 CFR 1.905–4T and 1.905–5T (as contained in 26 CFR part 1, revised as of April 1, 2007).

(ii) *Notification required.* If, as of November 7, 2007, the taxpayer has not satisfied the notification requirements described in § 1.905–3T and this section (as contained in 26 CFR part 1, revised as of April 1, 2007, as modified by Notice 90–26, 1990–1 CB 336, see § 601.601(d)(2)(ii)(*b*) of this chapter), with respect to a foreign tax redetermination described in paragraph (f)(2)(i) of this section, the taxpayer must notify the IRS of the foreign tax redetermination by filing an amended return, Form 1118 or 1116, and the statement required in paragraph (c) of this section for the taxable year with respect to which a redetermination of United States tax liability is required. Such notification must be filed no later than the due date (with extensions) of the original return for the taxpayer's first taxable year following the taxable year in which these regulations are first applicable. Where the foreign tax redetermination requires an individual to redetermine the individual's United States tax liability, and as a result of such foreign tax redetermination the amount of creditable taxes paid or accrued by such individual during the taxable year does not exceed the applicable dollar limitation in section 904(k), the individual shall not be required to file Form 1116 with the amended return for such taxable year if the individual satisfies the requirements of section 904(k). The rules of paragraphs (b)(1)(iv) and (v) of this section (concerning multiple redeterminations of United States tax liability for the same taxable year, and the carryback and carryover of unused foreign tax) shall apply.

(iii) *Taxpayers under the jurisdiction of the Large and Mid-Size Business Division.* If a taxpayer under the jurisdiction of the Large and Mid-Size Business Division is otherwise required under paragraph (f)(2)(ii) of this section to notify the IRS of a foreign tax redetermination described in paragraph (f)(2)(ii) of this section by filing an amended return, Form 1118, and the statement required in paragraph (c) of this section, such taxpayer may, in lieu of applying the rules of paragraph (f)(2)(ii) of this section, provide to the examiner the information described in paragraph (c) of this section during an examination of the return for the taxable year for which a redetermination of United States tax liability is required by reason of such foreign tax redetermination. The taxpayer must provide the information to the examiner on or before the date that is the later of May 5, 2008 or 120 days after the latest of the opening conference or the hand-delivery or postmark date of the opening letter concerning an examination of the return for the taxable year for which a redetermination of United States tax liability is required. However, if November 7, 2007 is more than 180 days after the latest of the opening conference or the hand-delivery or postmark date of the opening letter, the IRS, in its discretion, may accept such statement or require the taxpayer to comply with the rules of paragraph (f)(2)(ii) of this section. This paragraph (f)(2)(iii) shall not apply where the due date specified in paragraph (f)(2)(ii) of this section for providing notice of the foreign tax redetermination precedes the latest of the opening conference or the hand-delivery or postmark date of the opening letter concerning an examination of the return for the taxable year for which a redetermination of United States tax liability is required.

(iv) *Interest and penalties.* Interest shall be computed in accordance with paragraph (e) of this section. Failure to comply with the provisions of this paragraph (f)(2) shall subject the taxpayer to the penalty provisions of section 6689 and the regulations under that section.

(3) *Expiration date.* The applicability of this section expires on or before November 5, 2010.

[T.D. 9362, 72 FR 62784, Nov. 7, 2007; 72 FR 71787, Dec. 19, 2007]

§ 1.905–5T Foreign tax redeterminations and currency translation rules for foreign tax redeterminations occurring in taxable years beginning prior to January 1, 1987 (temporary).

(a) *In general.* This section sets forth rules governing the application of section 905(c) to foreign tax redeterminations occurring prior to January 1, 1987. However, the rules of this section also apply to foreign tax redeterminations occurring after December 31, 1986

with respect to foreign tax deemed paid under section 902 or section 960 with respect to pre-1987 accumulated profits (as defined in § 1.902–1(a)(10)(i).

(b) *Currency translation rules*—(1) *Foreign taxes paid by the taxpayer and certain foreign taxes deemed paid.* Foreign taxes paid in foreign currency that are paid by or on behalf of a taxpayer or deemed paid under section 960 (or under section 902 in a deemed distribution under section 1248) shall be translated into dollars at the rate of exchange for the date of the payment of the foreign tax. Refunds of such taxes shall be translated into dollars at the rate of exchange for the date of the refund.

(2) *Foreign taxes deemed paid on an actual distribution.* Foreign taxes deemed paid by a taxpayer under section 902 with respect to an actual distribution and refunds of such taxes shall be translated into dollars at the rate of exchange for the date of the distribution of the earnings to which the taxes relate.

(c) *Foreign tax redetermination.* The term ''foreign tax redetermination'' means a foreign tax redetermination as defined in § 1.905–3T(c).

(d) *Redetermination of United States tax liability*—(1) *In general.* A redetermination of United States tax liability is required with respect to any foreign tax redetermination subject to this section and shall be subject to the requirements of § 1.905–4T(b). The content of the notification required by this paragraph (d) shall be the same as provided in § 1.905–4T(c), except as modified by paragraphs (d) (2), (3), and (4) of this section.

(2) *Refunds.* In the case of any refund of foreign tax, the rate of exchange on the date of the refund shall be included in the information required by§ 1.905–4T(c)(2).

(3) *Foreign taxes deemed paid under section 902.* In the case of foreign taxes paid or accrued by a foreign corporation that are deemed paid or accrued under section 902 with respect to an actual distribution and with respect to which there was a redetermination of foreign tax, the United States taxpayer's information shall include, in lieu of the information required by § 1.905–4T(c)(3), the following: the foreign corporation's name and identifying number (if any); the date on which the foreign taxes were accrued and the dates on which the foreign taxes were paid; the amounts of the foreign taxes accrued or paid in foreign currency on each such date; the dates on which any foreign taxes were refunded and the amounts thereof; the dates and amounts of any dividend distributions made out of earnings and profits for the affected year or years; the rate of exchange on the date of any such distribution; and the amount of earnings and profits from which such dividends were paid for the affected year or years.

(4) *Foreign taxes deemed paid under section 960.* In the case of foreign taxes paid under section 960 (or under section 902 in the case of an amount treated as a dividend under section 1248), the rate of exchange determined under § 1.964–1 for translating accrued foreign taxes shall be included in the information required by ;§ 1.905–4T(c)(3).

(e) *Exception for de minimis currency fluctuations.* A United States taxpayer need not notify the Service of a foreign tax redetermination that results solely from a currency fluctuation if the amount of such redetermination with respect to the foreign country is less than the lesser of ten thousand dollars or two percent of the total dollar amount of the foreign tax, prior to the adjustment, initially accrued with respect to that foreign country for the taxable year.

(f) *Special effective/applicability date.* See § 1.905–4T(f) for the applicability date of notification requirements relating to foreign tax redeterminations that affect foreign taxes deemed paid under section 902 or section 960 with respect to pre-1987 accumulated profits accumulated in taxable years of a foreign corporation beginning on or after January 1, 1987. Failure to comply with the provisions of this section shall subject the taxpayer to the penalty provisions of section 6689 and the regulations thereunder. In no case, however, shall this paragraph operate to extend the statute of limitations provided by section 6511(d)(3)(A).

(g) *Expiration date*. The applicability of this section expires on or before November 5, 2010.

[T.D. 8210, 53 FR 23618, June 23, 1988, as amended by T.D. 9362, 72 FR 62787, Nov. 7, 2007]

§ 1.907–0 Outline of regulation provisions for section 907.

This section lists the paragraphs contained in §§ 1.907(a)–0 through 1.907(f)–1.

§ 1.907(a)–0 Introduction (for taxable years beginning after December 31, 1982).

(a) Effective dates.
(b) Key terms.
(c) FOGEI tax limitation.
(d) Reduction of creditable FORI taxes.
(e) FOGEI and FORI.
(f) Posted prices.
(g) Transitional rules.
(h) Section 907(f) carrybacks and carryovers.
(i) Statutes covered.

§ 1.907(a)–1 Reduction in taxes paid on FOGEI (for taxable years beginning after December 31, 1982).

(a) Amount of reduction.
(b) Foreign taxes paid or accrued.
(1) Foreign taxes.
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(c) Limitation level.
(1) In general.
(2) Limitation percentage of corporations.
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(4) Losses.
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(d) Illustrations.
(e) Effect on other provisions.
(1) Deduction denied.
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(3) Section 78 dividend.
(f) Section 904 limitation.

§ 1.907(b)–1 Reduction of creditable FORI taxes (for taxable years beginning after December 31, 1982).

§ 1.907(c)–1 Definitions relating to FOGEI and FORI (for taxable years beginning after December 31, 1982).

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[T.D. 8338, 56 FR 11063, Mar. 15, 1991; 56 FR 21926, May 13, 1991; T.D. 8655, 61 FR 516, Jan. 8, 1996]

§ 1.907(a)–0 Introduction (for taxable years beginning after December 31, 1982).

(a) *Effective dates*. The provisions of §§ 1.907(a)–0 through 1.907(f)–1 apply to taxable years beginning after December 31, 1982. For provisions that apply to taxable years beginning before January 1, 1983, see §§ 1.907(a)–0A through 1.907(f)–1A.

(b) *Key terms*. For purposes of the regulations under section 907—

(1) *FOGEI* means foreign oil and gas extraction income.

(2) *FORI* means foreign oil related income.

(3) *FOGEI taxes* mean foreign oil and gas extraction taxes as defined in section 907(c)(5).

(4) *FORI taxes* means foreign taxes on foreign oil related income. See § 1.907(c)–3.

(c) *FOGEI tax limitation*. Section 907(a) limits the foreign tax credit for taxes paid or accrued on FOGEI. See § 1.907(a)–1.

(d) *Reduction of creditable FORI taxes*. Section 907(b) recharacterizes FORI taxes as non-creditable deductible expenses to the extent that the foreign law imposing the FORI taxes is structured, or in fact operates, so that the amount of tax imposed with respect to FORI will be materially greater, over a reasonable period of time, than the amount generally imposed on income that is neither FOGEI nor FORI. See § 1.907(b)–1.

(e) *FOGEI and FORI*. FOGEI includes the taxable income from the extraction of minerals from oil or gas wells by a taxpayer (or another person) and from the sale or exchange of assets used in the extraction business. FORI includes taxable income from the activities of processing oil and gas into their primary products, transporting or distributing oil and gas and their primary products, and from the disposition of assets used in these activities. For this purpose, a disposition includes only a sale or exchange. FOGEI and FORI may also include taxable income from the performance of related services or from the lease of related property and certain dividends, interest, or amounts described in section 951(a). See §§ 1.907(c)–1 through 1.907(c)–3.

(f) *Posted prices*. Certain sales prices are disregarded when computing FOGEI for purposes of chapter 1 of the Code. See § 1.907(d)–1.

(g) *Transitional rules*. Section 907(e) provides rules for the carryover of unused FOGEI taxes from taxable years beginning before January 1, 1983, and carryback of FOGEI taxes arising in

taxable years beginning after December 31, 1982. See § 1.907(e)–1.

(h) *Section 907(f) carrybacks and carryovers.* FOGEI taxes disallowed under section 907(a) may be carried back or forward to other taxable years. These FOGEI taxes may be absorbed in another taxable year to the extent of the lesser of the separate excess extraction limitation or the excess limitation in the general limitation category (section 904(d)(1)(I)) for the carryback or carryover year. See § 1.907(f)–1.

(i) *Statutes covered.* The regulations under section 907 are issued as a result of the enactment of section 601 of the Tax Reduction Act of 1975, of section 1035 of the Tax Reform Act of 1976, of section 301(b)(14) of the Revenue Act of 1978, of section 211 of the Tax Equity and Fiscal Responsibility Act of 1982 and of section 1012(g)(6) (A)–(B) of the Technical and Miscellaneous Revenue Act of 1988.

[T.D. 8338, 56 FR 11065, Mar. 15, 1991]

§ 1.907(a)–1 Reduction in taxes paid on FOGEI (for taxable years beginning after December 31, 1982).

(a) *Amount of reduction.* FOGEI taxes are reduced by the amount by which they exceed a limitation level (as defined in paragraph (c) of this section).

(b) *Foreign taxes paid or accrued.* For purposes of the regulations under section 907—

(1) *Foreign taxes.* The term ''foreign taxes'' means income, war profits, or excess profits taxes of foreign countries or possessions of the United States otherwise creditable under section 901 (including those creditable by reason of section 903).

(2) *Foreign taxes paid or accrued.* The terms ''foreign taxes paid or accrued,'' ''FOGEI taxes paid or accrued,'' and ''FORI taxes paid or accrued'' include foreign taxes deemed paid under sections 902 and 960. Unless otherwise expressly provided, these terms do not include foreign taxes deemed paid by reason of sections 904(c) and 907(f).

(c) *Limitation level*—(1) *In general.* The limitation level is FOGEI for the taxable year multiplied by the limitation percentage for that year.

(2) *Limitation percentage for corporations.* A corporation's limitation percentage is the highest rate of tax specified in section 11(b) for the particular year.

(3) *Limitation percentage for individuals.* Section 907(a)(2)(B) provides that the limitation percentage for individual taxpayers is the effective rate of tax for those taxpayers. The effective rate of tax is computed by dividing the entire tax, before the credit under section 901(a) is taken, by the taxpayer's entire taxable income.

(4) *Losses.* (i) For purposes of determining whether income is FOGEI, a taxpayer's FOGEI will be recharacterized as foreign source non-FOGEI to the extent that FOGEI losses for preceding taxable years beginning after December 31, 1982, exceed the amount of FOGEI already recharacterized. See § 1.907(c)–1(c). However, taxes that were paid or accrued on the recharacterized FOGEI will remain FOGEI taxes.

(ii) Taxes paid or accrued by a person to a foreign country may be FOGEI taxes even though that person has under U.S. law a net operating loss from sources within that country.

(iii) For purposes of determining whether income is FOGEI, a taxpayer's income will be treated as income from sources outside the United States even though all or a portion of that income may be resourced as income from sources within the United States under section 904(f) (1) and (4).

(5) *Priority.* (i) Section 907(a) applies before section 908, relating to reduction of credit for participation in or cooperation with an international boycott.

(ii) Section 901(f) (relating to certain payments with respect to oil and gas not considered as taxes) applies before section 907.

(d) *Illustrations.* Paragraphs (a) through (c) of this section are illustrated by the following examples.

Example 1. M, a U.S. corporation, uses the accrual method of accounting and the calendar year as its taxable year. For 1984, M has $20,000 of FOGEI, derived from operations in foreign countries X and Y, and has accrued $11,500 of foreign taxes with respect to FOGEI. The highest tax rate specified in section 11(b) for M's 1984 taxable year is 46 percent. Pursuant to section 907(a), M's FOGEI taxes limitation level for 1984 is $9,200 (46% × $20,000). The foreign taxes in excess of this limitation level ($2,300) may be carried

back or forward. See section 907(f) and § 1.907(f)–1 and section 907(e) and § 1.907(e)–1.

Example 2. The facts are the same as in *Example 1* except that M is a partnership owned equally by U.S. citizens A and B who each file as unmarried individuals and do not itemize deductions. Pursuant to section 905(a), A and B have elected to credit foreign taxes in the year accrued. The total amount of foreign taxes accrued by A and B with respect to their distributive shares of M's FOGEI is $11,500 ($5,750 accrued by A and $5,750 accrued by B). A and B have no other FOGEI. A's only taxable income for 1984 is his 50% distributive share ($10,000) of M's FOGEI and A has a preliminary U.S. tax liability of $1,079. B has $112,130 of taxable income for 1984 (including his 50% distributive share ($10,000) of M's FOGEI) and has a preliminary U.S. tax liability of $44,000. Pursuant to section 907(a), A's FOGEI taxes limitation level for 1984 is $1,079 (($1,079/$10,000) × $10,000) and B's FOGEI taxes limitation level for 1984 is $3,924 (($44,000/$112,130) × $10,000).

(e) *Effect on other provisions*—(1) *Deduction denied.* If a credit is claimed under section 901, no deduction under section 164(a)(3) is allowed for the amount of the FOGEI taxes that exceed a taxpayer's limitation level for the taxable year. See section 275(a)(4)(A). Thus, FOGEI taxes disallowed under section 907(a) are not added to the cost or inventory amount of oil or gas.

(2) *Reduction inapplicable.* The reduction under section 907(a) does not apply to a taxpayer that deducts foreign taxes and does not claim the benefits of section 901 for a taxable year.

(3) *Section 78 dividend.* The reduction under section 907(a) has no effect on the amount of foreign taxes that are treated as dividends under section 78.

(f) *Section 904 limitation.* FOGEI taxes as reduced under section 907(a) are creditable only to the extent permitted by the general limitation of section 904(d)(1)(I).

[T.D. 8338, 56 FR 11066, Mar. 15, 1991]

§ 1.907(b)–1 Reduction of creditable FORI taxes (for taxable years beginning after December 31, 1982).

If the foreign law imposing a FORI tax (as defined in § 1.907(c)–3) is either structured in a manner, or operates in a manner, so that the amount of tax imposed on FORI is generally materially greater than the tax imposed by the foreign law on income that is neither FORI nor FOGEI (''described manner''), section 907(b) provides a special rule which limits the amount of FORI taxes paid or accrued by a person to a foreign country which will be considered income, war profits, or excess profits taxes. Section 907(b) will apply to a person regardless of whether that person is a dual capacity taxpayer as defined in § 1.901–2(a)(2)(ii)(A). (In general, a dual capacity taxpayer is a person who pays an amount to a foreign country part of which is attributable to an income tax and the remainder of which is a payment for a specific economic benefit derived from that country.) Foreign law imposing a tax on FORI will be considered either to be structured in or to operate in the described manner only if, under the facts and circumstances, there has been a shifting of tax by the foreign country from a tax on FOGEI to a tax on FORI.

[T.D. 8338, 56 FR 11066, Mar. 15, 1991]

§ 1.907(c)–1 Definitions relating to FOGEI and FORI (for taxable years beginning after December 31, 1982).

(a) *Scope.* This section explains the meaning to be given certain terms and items in section 907(c) (1), (2), and (4). See also §§ 1.907(a)–0(b) and 1.907(c)–2 for further definitions.

(b) *FOGEI*—(1) *General rule.* Under section 907(c)(1), FOGEI means taxable income (or loss) derived from sources outside the United States and its possessions from the extraction (by the taxpayer or any other person) of minerals from oil or gas wells located outside the United States and its possessions or from the sale or exchange of assets used by the taxpayer in the trade or business of extracting those minerals. Extraction of minerals from oil or gas wells will result in gross income from extraction in every case in which that person has an economic interest in the minerals in place. For other circumstances in which gross income from extraction may arise, see paragraph (b)(3) of this section. For determination of the amount of gross income from extraction, see paragraph (b)(2) of this section. For definition of the phrase ''assets used by the taxpayer in the trade or business'' and for rules relating to that type of FOGEI, see paragraph (e)(1) of this section. The

term ''minerals'' is defined in paragraph (f)(1) of this section. For determination of taxable income, see paragraph (f)(2) of this section. FOGEI includes, in addition, items listed in section 907(c)(3) (relating to dividends, interest, partnership distributions, etc.) and explained in §1.907(c)–2. For the reduction of what would otherwise be FOGEI by losses incurred in a prior year, see section 907(c)(4) and paragraph (c) of this section.

(2) *Amount.* The gross income from extraction is determined by reference to the fair market value of the minerals in the immediate vicinity of the well. Fair market value is determined under paragraph (b)(6) of this section.

(3) *Other circumstances.* Gross income from extraction or the sale or exchange of assets described in section 907(c)(1)(B) includes income from any arrangement, or a combination of arrangements or transactions, to the extent the income is in substance attributable to the extraction of minerals or such a sale or exchange. For instance, a person may have gross income from such a sale or exchange if the person purchased minerals from a foreign government at a discount and the discount reflects an arm's-length amount in consideration for the government's nationalization of assets that person owned and used in the extraction of minerals.

(4) *Income directly related to extraction.* Gross income from extraction includes directly related income under paragraph (g) of this section.

(5) *Income not included.* FOGEI as otherwise determined under this paragraph (b), nevertheless, does not include income to the extent attributable to marketing, distributing, processing or transporting minerals or primary products. Income from the purchase and sale of minerals is not ordinarily FOGEI. If the foreign taxes paid or accrued in connection with income from a purchase and sale are not creditable by reason of section 901(f), that income is not FOGEI. A taxpayer to whom section 901(f) applies is not a producer.

(6) *Fair market value.* For purposes of this paragraph (b), the fair market value of oil or gas in the immediate vicinity of the well depends on all of the facts and circumstances as they exist relative to a party in any particular case. The facts and circumstances that may be taken into account include, but are not limited to, the following—

(i) The facts and circumstances pertaining to an independent market value (if any) in the immediate vicinity of the well,

(ii) The facts and circumstances pertaining to the relationships between the taxpayer and the foreign government. If an independent fair market value in the immediate vicinity of the well cannot be determined but fair market value at the port, or a similar point, in the foreign country can be determined (port price), an analysis of the arrangement between the taxpayer and the foreign government that retains a share of production could be evidence of the appropriate, arm's-length difference between the port price and the field price, and

(iii) The other facts and circumstances pertaining to any difference in the producing country between the field and port prices.

(7) *Economic interest.* For purposes of this paragraph (b), the term ''economic interest'' means an economic interest as defined in §1.611–1(b)(1), whether or not a deduction for depletion is allowable under section 611.

(c) *Carryover of foreign oil extraction losses*—(1) *In general.* Pursuant to section 907(c)(4), the determination of FOGEI for a particular taxable year takes into account a foreign oil extraction loss incurred in prior taxable years beginning after December 31, 1982. There is no time limitation on this carryover of foreign oil extraction losses. Section 907(c)(4) does not provide for any carryback of these losses. Section 907(c)(4) operates solely for purposes of determining FOGEI and thus operates independently of section 904(f).

(2) *Reduction.* That portion of the income of the taxpayer for the taxable year which but for this paragraph (c) would be treated as FOGEI is reduced (but not below zero) by the excess of—

(i) The aggregate amount of foreign oil extraction losses for preceding taxable years beginning after December 31, 1982, over

(ii) The aggregate amount of reductions under this paragraph (c) for preceding taxable years beginning after December 31, 1982.

(3) *Foreign oil extraction loss defined*—(i) *In general*. For purposes of this paragraph (c), the term ''foreign oil extraction loss'' means the amount by which the gross income for the taxable year that is taken into account in determining FOGEI for that year is exceeded by the sum of the deductions properly allocated and apportioned to that gross income as determined under paragraph (f)(2) of this section). A person can have a foreign oil extraction loss for a taxable year even if the person has not chosen the benefits of section 901 for that year.

(ii) *Items not taken into account*. For purposes of paragraph (c)(3)(i) of this section, the following items are not taken into account—

(A) The net operating loss deduction allowable for the taxable year under section 172(a),

(B) Any foreign expropriation loss (as defined in section 172(h)) for the taxable year, and

(C) Any loss for the taxable year which arises from fire, storm, shipwreck, or other casualty, or from theft.

A loss mentioned in paragraph (c)(3)(ii)(B) or (C) of this section is taken into account, however, to the extent compensation (for instance by insurance) for the loss is included in gross income.

(4) *Affiliated groups*. The foreign oil extraction loss of an affiliated group of corporations (within the meaning of section 1504(a)) that files a consolidated return is determined on a group basis. If the group does not have a foreign oil extraction loss, the foreign oil extraction loss of a member of that group will not reduce on a separate basis that member's FOGEI for a later taxable year. For special rules affecting the foreign oil extraction loss in the case of certain related domestic corporations that are not members of the same affiliated group, see section 904(i).

(5) *FOGEI taxes*. If FOGEI is reduced pursuant to this paragraph (c) (and thereby recharacterized as non-FOGEI income), any foreign taxes imposed on the FOGEI that is recharacterized as other income retain their character as FOGEI taxes. See section 907(c)(5).

(6) *Examples*. The provisions of this paragraph (c) may be illustrated by the following examples.

Example 1. (i) *Facts*. X, a U.S. corporation using the accrual method of accounting and the calendar year as its taxable year, is engaged in extraction activities in three foreign countries. X has only the following combined foreign tax items for the three countries (prior to the application of this paragraph (c)) for 1983, 1984, and 1985:

	1983	1984	1985
FOGEI	$(700)	$100	$450
FOGEI taxes	10	60	200
Net operating loss deduction	(200)	0	0
Foreign oil extraction loss allowable after adjustment for paragraph (c)(3)(ii) amounts	(500)	0	0
General limitation taxes other than FOGEI taxes	30	90	230

(ii) *1983*. Because X's FOGEI for 1983 is a loss of $(700), X's section 907(a) limitation for 1983 is $0 (.46 × $0). Thus, none of the FOGEI taxes paid or accrued in 1983 ($10) can be credited in 1983. They can, however, be carried back to 1981 or 1982 pursuant to the provisions of section 907(e)(2) and § 1.907(e)–1 and carried forward pursuant to the provisions of section 907(f) and § 1.907(f)–1.

(iii) *1984*. X's FOGEI for 1984, prior to the application of this paragraph (c), is $100. X has a foreign oil extraction loss for 1983 of $(500). This loss must be applied against X's preliminary FOGEI of $100 for 1984. Thus, X's FOGEI for 1984 is $0 and X has $(400) ($500 − $100) of foreign oil extraction loss from 1983 to be carried to 1985. Since X's FOGEI for 1984 is $0, its section 907(a) limitation is $0 (.46 × $0). Therefore, none of the FOGEI taxes paid or accrued in 1984 ($60) can be credited in 1984. They can, however, be carried back pursuant to the provisions of section 907(e)(2) and § 1.907(e)–1 and carried forward pursuant to the provisions of section 907(f) and § 1.907(f)–1.

(iv) *1985*. X's FOGEI for 1985, prior to the application of this paragraph (c), is $450. X's remaining foreign oil extraction loss carryover from 1983 is $(400) and this must be applied against X's preliminary FOGEI of $450 for 1985. Thus, X's FOGEI for 1984 is $50 ($450 − $400). X's section 907 (a) limitation is $23 (.46 × $50). Therefore, $23 of the FOGEI taxes paid or accrued in 1985, together with the other $230 of general limitation taxes, can be credited in 1985, subject to the general limitation of section 904(d)(1)(E) (as in effect prior to 1987). The excess of FOGEI taxes, $177 ($200 − $23), can be carried back pursuant to the provisions of section 907(e)(2) and § 1.907(e)–1 and carried forward pursuant to

the provisions of section 907(f) and § 1.907(f)–1.

Example 2. (i) *Facts.* The facts are the same as in *Example 1* except that X's paragraph (c)(3)(ii) items for 1983 allocable to FOGEI are $(800) instead of $(200). FOGEI remains a loss of $(700). Thus, X does not have a foreign oil extraction loss for 1983 because it has $100 of FOGEI when its paragraph (c)(3)(ii) items are not taken into account ($(700) + $800).

(ii) *1983.* The results are the same as in Example 1.

(iii) *1984.* Although X had FOGEI loss of $(700) in 1983, there is not a loss that can be carried forward after adjustment for paragraph (c)(3)(ii) items. Thus, X's FOGEI for 1984 is not reduced by the 1983 loss. X's section 907(a) limitation for 1984 is $46 (.46 × $100). Therefore, $46 of the FOGEI taxes paid or accrued in 1984, together with the other $90 of general limitation taxes, can be credited in 1984, subject to the general limitation of section 904(d)(1)(E) (as in effect prior to 1987). The excess of $14 ($60 − $46) can be carried back to 1982 pursuant to the provisions of section 907(e)(2) and § 1.907(e)–1 and carried forward pursuant to the provisions of section 907(f) and § 1.907(f)–1.

(iv) *1985.* Since there is no foreign oil extraction loss for either 1983 or 1984 to be applied in 1985, X's FOGEI for 1985 is $450. Thus, its section 907(a) limitation for 1985 is $207 (.46 × $450) and all of its FOGEI taxes paid or accrued in 1985 ($200), together with the other $230 of general limitation taxes, can be credited in 1985, subject to the general limitation of section 904(d)(1)(E) (as in effect prior to 1987). FOGEI taxes in the amount of $10 from 1983 and $14 from 1984 may be carried forward to 1985 if they have not been used in carryback years. However, because the excess section 907(a) limitation for 1985 is only $7, that is the maximum potential FOGEI taxes from 1983 or 1984 that may be used in 1985.

Example 3. (i) *Facts.* Y, a U.S. corporation using the accrual method of accounting and the calendar year as its taxable year, is engaged in extraction activities in three foreign countries. Y's only foreign taxable income is income subject to the general limitation of section 904(d)(1)(E) (as in effect prior to 1987). Y has no paragraph (c)(3)(ii) items. Y has the following foreign tax items for 1983 and 1984:

	1983	1984
FOGEI	$(400)	$300
Other foreign taxable income	250	200
U.S. taxable income	1,000	1,100
Worldwide taxable income	850	1,600
FOGEI taxes	10	180
Other general limitation taxes	50	40
Foreign oil extraction loss	(400)	0

(ii) *1983*—(A) *Section 907(a) limitation.* Because Y's FOGEI for 1983 is a loss of $(400), Y's section 907(a) limitation for 1983 is $0. Thus, none of the FOGEI taxes paid or accrued in 1983 ($10) can be credited in 1983. They can, however, be carried back to 1981 or 1982 pursuant to the provisions of section 907(e)(2) and § 1.907(e)–1 and carried forward pursuant to the provisions of section 907(f) and § 1.907(f)–1.

(B) *Section 904(d) fraction.* Y has a foreign loss of $(150) ($(400 + $250) for 1983. Thus, its fraction for purposes of determining its general limitation of section 904(d)(1)(E) is $0/$850.

(iii) *1984*—(A) *Section 907(a) limitation.* Y's foreign oil extraction loss for 1983 is $(400). Applying this loss to its preliminary FOGEI for 1984 ($300) eliminates all of Y's FOGEI for 1984. Because Y's FOGEI for 1984 is $0, its section 907(a) limitation is also $0. Thus, none of the FOGEI taxes paid or accrued in 1984 ($180) can be credited in 1984. They can, however, be carried back to 1982 pursuant to the provisions of section 907(e)(2) and § 1.907(e)–1 and carried forward pursuant to the provisions of section 907(f) and § 1.907(f)–1. Y has a remaining foreign oil extraction loss of $(100) from 1983 to be carried to 1985.

(B) *Section 904(d) fraction.* Y's preliminary foreign taxable income for purposes of determining its general limitation of section 904(d)(1)(E) is $500 ($300 + $200). However, Y has an overall foreign loss from 1983 of $(150) ($(400) + $250) and thus, pursuant to section 904(f), Y must recharacterize $150 (lesser of $150 or 50% of $500) of its 1984 foreign taxable income as U.S. taxable income. Thus, Y's fraction for purposes of determining its general limitation of section 904(d)(1)(E) for 1984 is $350/$1,600.

Example 4. (i) *Facts.* Assume the same facts as in *Example 3* except that Y has the following foreign tax items:

	1983	1984	1985
FOGEI		$(100)	$225
Other foreign source taxable income subject to the general limitation of section 904(d)(1)(E)	$(50)		
U.S. source taxable income	50		
Worldwide taxable income		(100)	225
FOGEI taxes		10	125
Foreign oil extraction loss		(100)	

(ii) *1983.* For 1983, Y has a section 904(d)(1)(E) overall foreign loss account of $50; see section 904(f) and § 1.904(f)–1(b).

(iii) *1984.* Because Y's FOGEI for 1984 is a loss of $(100), Y's section 907(a) limitation for 1984 is $0. Thus, none of the FOGEI taxes paid or accrued in 1984 ($10) can be credited in 1984. They can, however, be carried back under the provisions of section 907(e)(2) and § 1.907(e)–1 and carried forward under the provisions of section 907(f) and § 1.907(f)–1.

(iv) *1985*. Y's FOGEI loss of $(100) for 1984 is carried forward to 1985 and offsets FOGEI income in that amount in 1985. The entire section 904(d)(1)(E) overall foreign loss account of $50 is recaptured in 1985; therefore, Y has $75 of foreign source income and $50 of U.S. source income. However, Y has $125 of FOGEI since, for purposes of section 907(a), the $50 resourced by section 904(f) will be treated as income from sources outside the United States; see §1.907(a)–1(c)(4)(iii). Accordingly, Y's section 907(a) limitation is $57.50 (.46 × $125). Y's section 904(d)(1)(E) limitation is, however, only $34.50 (.46 × $75). Thus, Y may claim a foreign tax credit of $34.50 in 1985. Y may carry back or carry forward $23 ($57.50–$34.50) and that amount is not subject to the section 907(a) limitation in the carry to year. In addition, $67.50 ($125 – $57.50) may be carried back pursuant to the provisions of section 907(e)(2) and §1.907(e)–1 and carried forward pursuant to the provisions of section 907(f) and §1.907(f)–1. This amount is subject to the section 907(a) limitation in the carry to year.

(d) *FORI*—(1) *In general*. Section 907(c)(2) defines FORI to include taxable income from the processing of oil and gas into their primary products, from the transportation or distribution and sale of oil and gas and their primary products, from the disposition of assets used in these activities and from the performance of any other related service. FORI may also include, under section 907(c)(3), certain dividends, interest, or amounts described in section 951(a). This paragraph (d) defines certain terms and items applicable to FORI.

(2) *Transportation*. Gross income from transportation of minerals or primary products (''gross transportation income'') is gross income arising from carrying minerals or primary products between two places (including time or voyage charter hires) by any means of transportation, such as a vessel, pipeline, truck, railroad, or aircraft. Except for directly related income under paragraphs (d)(7) and (g) of this section, gross transportation income does not include gross income received by a lessor from a bareboat charter hire of a means of transportation, certain other rental income, or income from the performance of certain services.

(3) *Distribution or sale*. The term ''distribution or sale'' means the sale or exchange of minerals or primary products to processors, users who purchase, store, or use in bulk quantities, other persons for further distribution, retailers, or consumers. Gross income from distribution or sale includes interest income attributable to the distribution of minerals or primary products on credit.

(4) *Processing*. The term ''processing'' means the destructive distillation, or a process similar in effect to destructive distillation, of crude oil and the processing of natural gas into their primary products including processes used to remove pollutants from crude oil or natural gas.

(5) *Primary product from oil*. The term ''primary product'' (in the case of oil) means all products derived from the processing of crude oil, including volatile products, light oils (such as motor fuel and kerosene), distillates (such as naphtha), lubricating oils, greases and waxes, and residues (such as fuel oil).

(6) *Primary product from gas*. The term ''primary product'' (in the case of gas) means all gas and associated hydrocarbon components from gas wells or oil wells, whether recovered at the lease or upon further processing, including natural gas, condensates, liquefiable petroleum gases (such as ethane, propane, and butane), and liquid products (such as natural gasoline).

(7) *Directly related income*. FORI also includes directly related income under paragraph (g) of this section.

(e) *Assets used in a trade or business*—(1) *In general*. The term ''assets used by the taxpayer in the trade or business'' in section 907(c) (1)(B) and (2)(D) means property primarily used in one or more of the trades or businesses that are section 907(c) activities. For purposes of this paragraph (e), assets used in a trade or business are assets described in section 1231(b) (applied without regard to any holding period or the character of the asset as being subject to the allowance for depreciation under section 167).

(2) *Section 907(c) activities*. Section 907(c) activities are those described in section 907(c)(1)(A) (for FOGEI) or (c)(2)(A) through (C) (for FORI). If an asset is used primarily in one or more section 907(c) activities, then the entire gain (or loss) will be considered attributable to those activities. For example, if a person uses a service station primarily to distribute primary products

from oil, then all of the gain (or loss) on the sale of the station is FORI even though the person uses the station to distribute products that are not primary products (such as tires or batteries). If an asset is not primarily used in one or more section 907(c) activities, then the entire gain or loss will not be FOGEI or FORI.

(3) *Stock.* Stock of any corporation (whether foreign or domestic) will not be treated as an asset used by a person in section 907(c) activities.

(4) *Losses on sale of stock.* If, under §1.861–8(e)(7), a loss on the sale, exchange, or disposition of stock is considered a deduction which is definitely related and allocable to FOGEI or FORI, then notwithstanding §1.861–8 (e)(7) and paragraph (f)(2) of this section, this loss shall be allocated and apportioned to the same class of income that would have been produced if there were capital gain from the sale, exchange or disposition.

(5) *Character of gain or loss.* Except in the case of stock, gain or loss from the sale, exchange or disposition of assets used in the trade or business may be FORI or FOGEI to the extent taken into account in computing taxable income for the taxable year, whether or not the gain or loss is ordinary income or ordinary loss.

(6) *Allocation of amount realized.* The amount realized from the sale, exchange or disposition of several assets in one transaction is allocated among them in proportion to their respective fair market values. This allocation is made under the principles set forth in §1.1245–1(a)(5) (relating to allocation between section 1245 property and nonsection 1245 property).

(7) *Interest.* Gross income from the sale, exchange or disposition of an asset used in a section 907(c) activity includes interest income from such a sale, exchange or disposition.

(f) *Terms and items common to FORI and FOGEI*—(1) *Minerals.* The term ''minerals'' means hydrocarbon minerals extracted from oil and gas wells, including crude oil or natural gas (as defined in section 613A(e)). The term includes incidental impurities from these wells, such as sulphur, nitrogen, or helium. The term does not include hydrocarbon minerals derived from shale oil or tar sands.

(2) *Taxable income.* Deductions to be taken into account in computing taxable income or net operating loss attributable to FOGEI or FORI are determined under the principles of §1.861–8. For an exception with regard to losses, see paragraph (e)(4) of this section.

(3) *Interest on working capital.* FORI and FOGEI may include interest on bank deposits or on any other temporary investment which is not in excess of funds reasonably necessary to meet the working capital requirements and the specifically anticipated business needs of the person that is engaged in the conduct of the activities described in section 907(c) (1) or (2).

(4) *Exchange gain or loss.* Exchange gain (and loss) may be FORI and FOGEI. For taxable years beginning after 1986, exchange gain or loss from a section 988 transaction may be FORI or FOGEI only if directly related to the business needs (under the principles of section 954(c)(1)(D)) attributable to the conduct of the section 907(c) activity.

(5) *Allocation.* Interest income and exchange gain (or loss) described, respectively, in paragraph (f) (3) and (4) of this section are allocated among FORI, FOGEI, and any other class of income relevant for purposes of the foreign tax credit limitations under any reasonable method which is consistently applied from year-to-year.

(6) *Facts and circumstances.* Income not described elsewhere in this section may be FOGEI or FORI if, under the facts and circumstances in the particular case, the income is in substance directly attributable to the activities described in section 907(c) (1) or (2). For example, assume that a producer in the North Sea suffers a casualty caused by an explosion, fire, and resulting destruction of a drilling platform. Insurance proceeds received for the platform's destruction in excess of the producer's basis is extraction income if the excess constitutes income from sources outside the United States. In addition, income from an insurance policy for business interruption may be extraction income to the extent the payments under the policy are geared directly to the loss of income from production and are treated as income from

sources outside the United States. Also, if an oil company's oil concession or assets used in extraction activities described in section 907(c)(1)(A) and located outside the United States are nationalized or expropriated by a foreign government, or instrumentality thereof, income derived from that nationalization or expropriation (including interest on the income paid pursuant to the nationalization or expropriation) is FOGEI. Likewise, if a company's assets used in the activities described in section 907(c)(2) (A) through (C) and located outside the United States are nationalized or expropriated by a foreign government, or instrumentality thereof, income (including interest on the income paid pursuant to the nationalization or expropriation) derived from the nationalization or expropriation will be FORI. Nationalization or expropriation is deemed to be a sale or exchange for purposes of section 907(c)(1)(B) and a disposition for purposes of section 907(c)(2)(D). In further example, assume that an oil company has an exclusive right to buy all the oil in country X from Y, an instrumentality of the foreign sovereign which owns all of the oil in X. The oil company does not have an economic interest in any oil in country X. Y has a temporary cash-flow problem and demands that the oil company make advance deposits for the purchase of oil not yet delivered. In return, Y grants the oil company a discount on the price of the oil when delivered. Income represented by the discount on the later disposition of the oil is FORI described in section 907(c)(2)(C). The result would be the same if Y credited the oil company with interest on the advance deposits, which had to be used to purchase oil (the interest income would be FORI).

(g) *Directly related income*—(1) *In general.* Section 907(c)(2)(E) and this paragraph (g) include in FORI, and this paragraph (g) includes in FOGEI, income from the performance of directly related services (as defined in paragraph (g)(2) of this section). This paragraph (g) also includes in FORI and FOGEI income from the lease or license of related property (as defined in paragraph (g)(3) of this section). Section 907(c)(2)(E) with regard to FORI and this paragraph (g) with regard to both FORI and FOGEI do not apply to a person if—

(i) Neither that person nor a related person (as defined in paragraph (g)(4) of this section) has FOGEI described in paragraph (b) of this section (other than paragraph (b)(4) of this section relating to directly related income) or FORI described in paragraph (d) of this section (other than paragraph (d)(7) of this section relating to directly related income), or

(ii) Less than 50 percent of that person's gross income from sources outside the United States which is related exclusively to the performance of services and from the lease or license of property described in paragraph (g) (2) and (3) of this section, respectively, is attributable to services performed for (or on behalf of), leases to, or licenses with, related persons, but

(iii) Paragraph (g)(1)(ii) of this section will not apply to a person if 50 percent or more of that person's total gross income from sources outside the United States is FOGEI and FORI (as both are described in paragraph (g)(1)(i) of this section).

A person described in paragraph (g)(1) (i) or (ii) of this section will, however, have directly related services income which is FOGEI if the income is so classified by reason of the income based on output test set forth in paragraph (g)(2)(i)(B) of this section.

(2) *Directly related services*—(i) *FOGEI.* (A) Income from directly related services will be FOGEI, as that term is defined in paragraph (b) (1) and (3) of this section, if those services are directly related to the active conduct of extraction (including exploration) of minerals from oil and gas wells. Paragraph (b)(1) of this section provides that, in order to have extraction income, a person must have an economic interest in the minerals in place. However, paragraph (b)(3) of this section recognizes that income arising from ''other circumstances'' is extraction income if that income is in substance attributable to the extraction of minerals.

(B) An example of ''other circumstances'' under paragraph (b)(3) of this section is the ''income based on output test.'' This income based on output test provides that, if the

amount of compensation paid or credited to a person for services is dependent on the amount of minerals discovered or extracted, the income of the person from the performance of the services will be directly related services income which is FOGEI. This test will apply whether or not the person performing the services has, or had, an economic interest in the minerals discovered or extracted.

(ii) *FORI.* With regard to the determination of directly related services income which is FORI, directly related services are those services directly related to the active conduct of the operations described in section 907(c)(2) (A) through (C). Those services include, for example, services performed in relation to the distribution of minerals or primary products or in connection with the operation of a refinery, or the types of services described in §1.954–6(d) (other than §1.954–6(d)(4) which relate to foreign base company shipping income.

(iii) *Recipient of the services.* Directly related services described in paragraph (g)(2) (i) and (ii) of this section may be performed for any person without regard to whether that person is a related person.

(iv) *Excluded services*—(A) *FOGEI.* Directly related services which produce FOGEI do not include insurance, accounting or managerial services.

(B) *FORI.* Directly related services which produce FORI do not, generally, include insurance, accounting or managerial services. These services will, however, produce FORI if they are performed by the person performing the operations described in section 907(c)(2) (A) through (C). For these purposes, insurance income which is FORI means taxable income as defined in section 832(a).

(3) *Leases and licenses.* A lease or license of related property is the lease or license of assets used (or held for use) by the lessor, licensor, or another person (including the lessee or a sublessee) in the active conduct of the activities described in section 907 (c)(1)(A) or (c)(2) (A) through (C). The leases or licenses described in this paragraph (g)(3) include, for example, a lease of a means of transportation under a bareboat charter hire, of drilling equipment used in extraction operations, or the license of a patent, know-how, or similar intangible property used in extracting, transporting, distributing or processing minerals or primary products. This paragraph (g)(3) applies without regard to whether the parties are related persons.

(4) *Related person.* A person will be treated as a related person for purposes of this paragraph (g) if that person would be so treated within the meaning of section 954(d)(3) (as applied by substituting the word ''corporation'' for the word ''controlled foreign corporation'') or that person is a partnership or partner described in section 707(b)(1).

(5) *Gross income.* A foreign corporation shall be treated as a domestic corporation for the purpose of applying the gross-income rules in paragraph (g)(1) (ii) and (iii) of this section.

(h) *Coordination with other provisions*—(1) *Certain adjustments.* The character of income as FOGEI or FORI is determined before making any adjustment under section 482 or section 907(d). For example, assume that X and Y are related parties, Y's only income is from the sale of oil that Y purchased from X, and FOGEI from X is diverted to Y through an arrangement described in paragraph (b)(3) of this section. Accordingly, Y has FOGEI. If under section 482 the Commissioner reallocates the FOGEI from Y to X, then Y's remaining income represents only a profit from distributing the oil, and thus is FORI. If the foreign taxes paid by Y on this income are otherwise creditable under section 901, the foreign taxes that are not refunded to Y retain their characterization as FOGEI taxes.

(2) *Section 901(f).* Section 901(f) (relating to certain payments with respect to oil and gas not considered as taxes) applies before section 907. Taxes disallowed by section 901(f) are added to the cost or inventory amount of oil or gas.

[T.D. 8338, 56 FR 11067, Mar. 15, 1991]

§ 1.907(c)–2 Section 907(c)(3) items (for taxable years beginning after December 31, 1982).

(a) *Scope.* This section provides rules relating to certain items listed in section 907(c)(3). The rules of this section

are expressed in terms of FORI but apply for determining FOGEI by substituting ''FOGEI'' for ''FORI'' whenever appropriate. FOGEI does not include interest described in section 907(c)(3)(A). Dividends paid prior to January 1, 1987, and described in section 907(c)(3)(B), as in effect prior to amendment by the Technical and Miscellaneous Revenue Act of 1988, are included in FORI and not FOGEI.

(b) *Dividend*—(1) *Section 1248 dividend*. A section 1248 dividend is a dividend described in section 907(c)(3)(A). Except as otherwise provided in this paragraph (b)(1), gain (or loss) from the disposition of stock in any corporation is not FOGEI or FORI. See §1.907(c)–1(e) (3) and (4).

(2) *Section 78 dividend*. A section 78 dividend is FORI to the extent it arises from a dividend described in section 907(c)(3)(A), or an amount described in section 907(c)(3)(C).

(c) *Taxes deemed paid*—(1) *Voting stock test*. Items described in section 907(c)(3)(A) or (C) are FORI only if a deemed-paid-tax test is met under the criteria of section 902 or 960. The purpose of this test is to require minimum direct or indirect ownership by a domestic corporation in the voting stock of a foreign corporation as a prerequisite for the item to qualify as FORI in the hands of the domestic corporation. The test is whether a domestic corporation would be deemed to pay any taxes of a foreign corporation when a dividend or an amount described in section 907(c)(3)(A) or (C), respectively, is included in the domestic corporation's gross income. In the case of interest described in section 907(c)(3)(A), the test is whether any taxes would be deemed paid if there were a hypothetical dividend.

(2) *Dividends and interest*. For purposes of section 907(c)(3)(A), a domestic corporation is deemed under section 902 to pay taxes in respect of dividends and interest received from a foreign corporation whether or not the foreign corporation:

(i) Actually pays or is deemed to pay taxes, or

(ii) In the case of interest, actually pays dividends.

This paragraph (c)(2) also applies to dividends received by a foreign corporation from a second-tier or third-tier foreign corporation (as defined in §1.902–1(a) (3)(i) and (4), respectively). In the case of interest received by a foreign corporation from another foreign corporation, this paragraph (c)(2) applies if the taxes of both foreign corporations would be deemed paid under section 902 (a) or (b) for purposes of applying section 902(a) to the same taxpayer which is a domestic corporation. In the case of interest received by any corporation (whether foreign or domestic), all members of an affiliated group filing a consolidated return will be treated as the same taxpayer under section 907(c)(3)(A) if the foreign taxes of the payor and (if the recipient is a foreign corporation) the foreign taxes of the recipient would be deemed paid under section 902 by at least one member. The term ''member'' is defined in §1.1502-1(b). Thus, for example, assume that P owns all of the stock of D1 and D2 and P. D1, and D2 are members of an affiliated group filing a consolidated return. Assume further that D1 owns all of the stock of F1 and D2 owns all of the stock of F2, where F1 and F2 are foreign corporations. Interest paid by F1 to P, D2, or F2 may be FORI.

(3) *Amounts included under section 951(a)*. For purposes of section 907(c)(3)(C), a domestic corporation is deemed under section 960 to pay taxes in respect of a foreign corporation, whether or not the foreign corporation actually pays taxes on the amounts included in gross income under section 951(a).

(d) *Amount attributable to certain items*—(1) *Certain dividends*—(i) *General rule*. The portion of a dividend described in section 907(c)(3)(A) that is FORI equals—

Amount of dividend × a/b

a = FORI accumulated profits in excess of FORI taxes paid or accrued, and

b = Total accumulated profits in excess of total foreign taxes paid or accrued.

This paragraph (d)(1)(i) applies even though the FORI accumulated profits arose in a taxable year of a foreign corporation beginning before January 1, 1983. Determination of the FORI amount of dividends under this paragraph (d)(1)(i) must be made separately for FORI accumulated profits and total

accumulated profits that arose in taxable years beginning before January 1, 1987, and for FORI accumulated profits and total accumulated profits that arose in taxable years beginning after December 31, 1986. Dividends are deemed to be paid first out of FORI and total accumulated profits that arose in table years beginning after December 31, 1986. With regard to FORI accumulated profits and total accumulated profits that arose in taxable years beginning after December 31, 1986, the portion of a dividend that is FORI equals—

Amount of dividend × a/b

a = Post-1986 undistributed FORI earnings determined under the principles of section 902(c)(1), and

b = Post-1986 undistributed earnings determined under the principles of section 902(c)(1).

(ii) *Cross-references*. See § 1.902–1(g) for the determination of a foreign corporation's earnings and profits and of those out of which a dividend is paid. See § 1.1248–2 or 1.1248–3 for the determination of the earnings and profits attributable to the sale or exchange of stock in certain foreign corporations.

(2) *Interest received from certain foreign corporations*. Interest described in section 907(c)(3)(A) is FORI to the extent the corresponding interest expense of the paying corporation is properly allocable and apportionable to the gross income of the paying corporation that would be FORI were that corporation a domestic corporation. This allocation and apportionment is made in a manner consistent with the rules of section 954(b)(5) and § 1.861–8(e)(2).

(3) *Dividends from domestic corporation*. The amount of a dividend from a corporation described in section 907(c)(3)(B), as in effect prior to amendment by the Technical and Miscellaneous Revenue Act of 1988, paid in a taxable year of that corporation beginning before December 31, 1986, that is FORI is determined under the principles of paragraph (d)(1)(i) of this section with respect to its current earnings and profits under section 316(a)(2) or its accumulated earnings and profits under section 316(a)(1), as the case may be.

(4) *Amounts with respect to which taxes are deemed paid under section 906(a)*—(i) *Portion attributable to FORI*. The portion of an amount described in section 907(c)(3)(C) that is FORI equals:

$$A \times \frac{B}{C}$$

A = Amount described in section 907(c)(3)(C)
B = FORI earnings and profits
C = Total earnings and profits

For taxable years ending after January 23, 1989, the facts and circumstances will be used to determined what part of the amount of the section 907(c)(3)(C) amount is directly attributable to FOGEI, FORI and other income.

(ii) *Earnings and profits*. Total earnings and profits are those of the foreign corporation for a taxable year under section 964 and the regulations under that section.

(5) *Section 78 dividend*. The portion of a section 78 dividend that will be considered FORI will equal the amount of taxes deemed paid under either section 902(a) or section 960(a)(1) with respect to the dividend to the extent the taxes deemed paid are FORI taxes under § 1.907(c)–3 (b) or (c). See § 1.907(c)–3(a)(1).

(6) *Special rule*. (i) No item in the formula described in paragraph (d)(1)(i) of this section includes amounts excluded from the gross income of a United States shareholder under section 959(a)(1).

(ii) With respect to a foreign corporation, earnings and profits in the formula described in paragraph (d)(4)(i) of this section do not include amounts excluded under section 959(b) from its gross income.

(7) *Deficits*—(i) *Allocation of deficits within a separate category*. In a taxable year in which a foreign corporation described in section 907(c)(3)(A) pays a dividend or has income that is subject to inclusion under section 951, if the foreign corporation has positive post—1986 undistributed earnings in a separate category but within that separate category there is a deficit in post-1986 undistributed earnings attributable to earnings other than FOGEI and FORI, that deficit shall be allocated ratably between the FOGEI and FORI post-1986

undistributed earnings within that separate category. Any deficit in post-1986 undistributed earnings attributable to either FOGEI or FORI shall be allocated first to FOGEI or FORI post-1986 undistributed earnings (as the case may be) to the extent thereof. Post-1986 undistributed FORI earnings are the post-1986 undistributed earnings (as defined in section 902 and the regulations under that section) attributable to FORI as defined in section 907(c) (2) and (3). Post-1986 undistributed FOGEI earnings are the post-1986 undistributed earnings (as defined in section 902 and the regulations under that section) attributable to FOGEI as defined in section 907(c) (1) and (3).

Example. Foreign corporation X for years 1987 and 1988 had the following undistributed earnings (none of which is income that is subject to inclusion under section 951) and foreign taxes:

	Earnings	Taxes
FOGEI	$800	$400
FORI	(750)	.....
Other	700	250
Total	$750	$650

On December 31, 1988, X paid a dividend of all of its post-1986 undistributed earnings to its sole shareholder Y. Under paragraph (d)(5) and (7)(i) of this section and § 1.907 (c)–2 (d)(5), $450 of Y's dividend is attributable to FOGEI ($50 from undistributed earnings plus a $400 section 78 dividend) and $950 is attributable to other earnings ($700 from undistributed earnings plus a $250 section 78 dividend).

(ii) *Deficits allocated among separate categories*. If a deficit in a separate category (''first separate category'') is allocated to another separate category (''second separate category'') under sections 902 and 960 pursuant to notice 88–71, 1988–2 CB 374 and the regulations under those sections, the following rules shall apply. Any deficit in post-1986 undistributed earnings attributable to either FOGEI (or FORI) from the first separate category shall be allocated to post-1986 undistributed earnings in the second separate category to the extent thereof in the following order:

(A) FOGEI (or FORI),

(B) FORI (or FOGEI), and

(C) Other income.

Any deficit in post-1986 undistributed earnings attributable to other income from the first separate category shall be allocated first to other post-1986 undistributed earnings and then ratably to FOGEI and FORI post—1986 undistributed earnings in the second separate category.

(iii) *Pre-1987 deficits*. The amount of a dividend paid by a foreign corporation described in section 907(c)(3)(A) out of positive pre-1987 earnings that is attributable to FOGEI and FORI shall be determined in a manner similar to that used in paragraph (d)(7) (i) and (ii) of this section except that the determinations shall be made on an annual basis.

(8) *Illustrations*. The application of this paragraph (d) is illustrated by the following examples.

Example 1. X, a domestic corporation, owns all of the stock of Y, a foreign corporation organized in country S. Y owns all of the stock of Z, a foreign corporation also organized in country S. Each corporation uses the calendar year as its taxable year. In 1983, Z has $150 of FOGEI earnings and profits and $250 of earnings and profits other than FOGEI or FORI. Assume that Z paid no taxes to S and X must include $100 in its gross income under section 951(a) with respect to Z. Under paragraph (d)(4)(i) of this section, $37.50 of the amount described in section 951(a) is FOGEI ($100 × $150/$400). the remaining $62.50 of the section 951(a) amount represents other income.

Example 2. Assume the same facts as in Example 1 except that the taxable year in question is 1988. In addition, under the facts and circumstances, it is determined that of the $100 section 951(a) amount included in X's gross income, $30 is directly attributable to Z's FOGEI activity, $60 is directly attributable to Z's FORI activity and $10 is directly attributable to Z's other activity. Accordingly, under paragraph (d)(4)(i), $30 will be FOGEI and $60 will be FORI to X.

Example 3. (i) Assume the same facts as in *Example 1*. Assume further that, in 1983, Z distributes its entire earnings and profits ($400) to Y which consists of a dividend of $300 and a section 959(a)(1) distribution of $100. Y has no other earnings and profits during 1983. Assume that the dividend and distribution are not foreign personal holding company income under section 954(c). Y pays no taxes to S. In 1983, Y distributes its entire earnings and profits to X.

(ii) Under paragraphs (c)(2) and (d)(1)(i) of this section, Y has FOGEI of $112.50, *i.e.*, the amount of the dividend received by Y ($300) multiplied by the fraction described in paragraph (d)(1)(i). The numerator of the fraction is Z's FOGEI accumulated profits in excess

of the FOGEI taxes paid ($112.50) and the denominator is Z's total accumulated profits in excess of total foreign taxes paid ($400) minus the amount excluded from Y's gross income under section 959(a)(1) ($100). The rule of paragraph (d)(6)(ii) of this section does not apply since X does not include any amount in its gross income under section 951(a) with respect to Y. If Y paid taxes to S, this paragraph (d) would apply to characterize those taxes as FOGEI taxes or other taxes. See §1.907(c)–3(a)(8) and Example 2 (iii) under §1.907(c)–3(e).

(iii) The distribution from Y to X is a dividend to the extent of $300, *i.e.*, the amount of the distribution ($400) minus the amount excluded from X's gross income under section 959(a)(1) ($100). Under paragraphs (d) (1)(i) and (6)(i) of this section, $112.50 of the dividend is FOGEI, *i.e.*, the amount of the dividend ($300) multiplied by a fraction. The numerator of the fraction is $112.50, *i.e.*, the FOGEI accumulated profits of Y in excess of FOGEI taxes paid ($150) minus the FOGEI accumulated profits of Y in excess of FOGEI taxes paid excluded from X's gross income under section 959(a)(1) ($37.50). The denominator of the fraction is $300, *i.e.*, the total accumulated profits of Y in excess of taxes paid ($400) minus the amount excluded from X's gross income under section 959(a)(1) ($100).

Example 4. Assume the same facts as in Example 1 with the following modifications: In 1983, Z's only earnings and profits are FORI earnings and profits which are included in X's gross income under section 951(a). Z distributes its entire earnings and profits to Y. In 1983, Y has total earnings and profits of $100 without regard to the dividend from Z, $60 of which are FORI earnings and profits. Y also has $40 which is included in X's gross income under section 951(a). Under paragraph (d)(6)(ii) of this section, the dividend from Z is disregarded for purposes of applying paragraph (d)(4)(i) of this section to the $40 included in X's gross income under section 951(a) with respect to Y. Accordingly, $24 of the amount described in section 951(a) is FORI ($40 × $60/$100). Had these circumstances existed in 1988, and if the $40 included in X's gross income under section 951(a) was directly attributable to FORI activity, all of that income would be FORI to X.

(e) *Dividends, interest, and other amounts from sources within a possession*. FORI includes the items listed in (A) and (C) to the extent attributable to FORI of a corporation that is created or organized in or under the laws of a possession of the United States.

(f) *Income from partnerships, trusts, etc*. FORI and FOGEI include a person's distributive share (determined under the principles of section 704) of the income of any partnership and amounts included in income under subchapter J of chapter 1 of the Code (relating to the taxation of trusts, estates, and beneficiaries) to the extent the income and amounts are attributable to FORI and FOGEI. For taxable years beginning after 1986, the principles of §1.904–5 (h) and (i) shall be applied to determine whether (and to what extent) a person's distributive share is FORI and FOGEI. Thus, for example, a less-than-10 percent corporate partner's share of income of the partnership would generally be treated as passive income to the partner, and not as FORI or FOGEI, unless an exception under §1.904–5 (h) and (i) applies.

[T.D. 8338, 56 FR 11071, Mar. 15, 1991]

§ 1.907(c)–3 FOGEI and FORI taxes (for taxable years beginning after December 31, 1982).

(a) *Tax characterization, allocation and apportionment*—(1) *Scope*. Paragraphs (a) (2) through (6) of this section provides rules for the characterization, allocation, and apportionment of the income taxes (other than withholding taxes) paid or accrued to a foreign country among FOGEI, FORI, and other income relevant for purposes of sections 907 and 904. Some of the rules in this section are expressed in terms of FOGEI taxes but they apply to FORI taxes by substituting ''FORI taxes'' for ''FOGEI taxes'' whenever appropriate. For the treatment of withholding taxes, see paragraph (a)(8) of this section. FOGEI taxes are determined without any reduction under section 907(a). In addition, determination of FOGEI taxes will not be affected by recharacterization of FOGEI by section 907(c)(4). See §1.907(c)–1(c)(5). Foreign taxes will not be characterized as creditable FORI taxes if section 907(b) and §1.907(b)–1 apply.

(2) *Three classes of income*. There are three classes of income: FOGEI, FORI, and other income.

(3) *More than one class in a foreign tax base*. If more than one class of income is taxed under one tax base under the law of a foreign country, the amount of pre-credit foreign tax for each base must be determined. This amount is the foreign taxes paid or accrued to that country for the base as increased

by the tax credits (if any) which reduced those taxes and were allowed in the country for that tax. More than one class of income is taxed under the same base, if, under a foreign country's law, deductions from one class of income may reduce the income of any other class and the classes are subject to foreign tax at the same rates.

(4) *Allocation of tax within a base.* If more than one class of income is taxed under the same base under a foreign country's law, the pre-credit foreign tax for the base is apportioned to each class of income in proportion to the income of each class. Tax credits are than allocated (under paragraph (a)(6) of this section) to the apportioned precredit tax. Income of a class over the deductions allowed under foreign law for, and which are attributable to, that class.

(5) *Modified gross income.* Modified gross income is not necessarily the same as gross income as defined for purposes of chapter 1 of the Internal Revenue Code. Modified gross income is determined with reference to the foreign tax base for gross income (or its equivalent). However, the characterization of the base as a particular class of income is governed by general principles of U.S. tax law. Thus, for example—

(i) Gross income from extraction is the fair market value of oil or gas in the immediate vicinity of the well (as determined under §1.907(c)–1(b)(6) (without any deductions)).

(ii) Whether cost of goods sold (or any other deduction) is a deduction from modified gross income and the amount of such a deduction is determined under foreign law.

(iii) Modified gross income includes items that are part of the foreign tax base even though they are not gross income under U.S. law so long as the foreign taxes paid on the base constitute creditable taxes under section 901 (including taxes described in section 903). For example, if a foreign country imposes a tax (creditable under section 901) on a tax base that includes in small part a percentage of the value of a company's oil reserves in place, modified gross income from extraction includes such a percentage of value solely for purposes of making the tax allocation in paragraph (a)(4) of this section.

(iv) Modified gross income from extraction is increased for purposes of this paragraph (a)(5) by the entire excess of the posted price over fair market value if the foreign country uses a posted price system or other pricing arrangement described in section 907(d) in imposing its income tax.

(v) Modified gross income from FORI is that income attributable to the activities in sections 907(c)(2) (A) through (C) and (E).

(vi) Modified gross income for any class may not include gross income that is not subject to taxation by the foreign country.

(6) *Allocation of tax credits.* The foreign taxes paid or accrued on a particular class of income equals the precredit tax on the class reduced (but not below zero) by the credits allowed under foreign law against the foreign tax on the particular class. Any tax credit attributable to a class that is not allocated to that class is allocated to the other class in the base or, if there are three classes in the base, is apportioned ratably among the taxes paid or accrued on the other two classes (as reduced in accordance with the preceding sentence).

(7) *Withholding taxes.* Paragraph (a)(2) through (6) of this section does not apply to withholding taxes imposed by a foreign country. FOGEI taxes may include withholding taxes imposed with respect to a distribution from a corporation. The portion of the total withholding taxes on a distribution that constitutes FOGEI taxes is determined by the portion of the distribution that is FOGEI. In addition, FOGEI taxes may include taxes imposed on a distribution described in section 959(a)(1) or on amounts described in section 959(b). The portion of the total withholding taxes imposed on a distribution described in section 959(a)(1) or on amounts described in section 959(b) is determined by reference to the portion of the amount included in gross income under section 951(a) that was FOGEI.

(b) *Dividenss—In general.* (i) FOGEI taxes deemed paid with respect to a dividend equal the total taxes deemed

paid with respect to the dividend multiplied by the fraction:

FOGEI taxes paid or accrued by the payor/Total foreign taxes paid or accrued by the payor.

(ii) With regard to dividends received in taxable years beginning after December 31, 1986, FOGEI taxes deemed paid with respect to a dividend equal the total taxes deemed paid with respect to the portion of the dividend within a separate category multiplied by the fraction:

$$\frac{\text{Post-1986 FOGEI taxes as determined under the principles of section 902(c)(2) that are allocable to that separate category}}{\text{Post-1986 foreign income taxes as determined under the principles of section 902(c)(2) that are allocable to that separate category.}}$$

(iii) This paragraph (b) applies to a dividend described in section 907(c)(3)(A) (including a section 1248 dividend) with reference to the particular taxable year or years of those accumulated profits out of which a dividend is paid. Determination of FOGEI taxes under this paragraph (b) must be made separately.

(A) For FOGEI taxes paid on FOGEI accumulated profits and total taxes paid on accumulated profits that arose in taxable years beginning before January 1, 1987, to which paragraph (b)(1)(i) of this section applies, and

(B) For FOGEI taxes paid on FOGEI accumulated profits and total taxes paid on accumulated profits that arose in taxable years beginning after December 31, 1986, to which paragraph (b)(1)(ii) of this section applies.

For purposes of these determinations, dividends are deemed to be paid first out of FOGEI and total accumulated profits that arose in taxable years beginning after December 31, 1986. See §1.907(c)–2(d)(1)(i). See section 960(a)(3) and §1.960–2 relating to distributions that are treated as dividends for purposes of section 902.

(2) *Section 78 dividend*. There are no FOGEI taxes with respect to section 78 dividends.

(c) *Includable amounts under section 951(a)*. (1) FOGEI taxes deemed paid with respect to an amount includable in gross income under section 951(a) equal the total taxes deemed paid with respect to that amount multiplied by the fraction:

$$\frac{\text{FOGEI taxes paid or accrued by the foreign corporation}}{\text{Total foreign taxes paid or accrued by the foreign corporation.}}$$

(2) With regard to an amount includable in gross income under section 951(a) in taxable years beginning after December 31, 1986, FOGEI taxes deemed paid with respect to that amount equal the total taxes deemed paid with respect to that amount within a separate category multiplied by the fraction:

$$\frac{\text{Post-1986 FOGEI taxes as determined under the principles of section 902(c)(2) that are allocable to that separate category}}{\text{Post-1986 foreign income taxes as determined under the principles of section 902(c)(2) that are allocable to that separate category.}}$$

Taxes in the fraction in this paragraph (c)(2) include only those foreign taxes that may be deemed paid under section 960(a) by reason of such inclusion. See §§ 1.960–1(c)(3) and 1.960–2(c).

(d) *Partnerships*. A partner's distributive share of the partnership's FOGEI taxes is determined under the principles of section 704.

(e) *Illustrations*. The application of this section may be illustrated by the following examples.

Example 1. X, a domestic corporation, owns all of the stock of Y, a foreign corporation organized in country S. Y owns all of the stock of Z, a foreign corporation organized in country T. Each corporation used the calendar year as its taxable year. In 1983, X includes in its gross income an amount described in section 951(a) with respect to Z. Assume that the taxes deemed paid under section 902(a) by X by reason of such an inclusion is $70. Assume further that Z paid total taxes of $120, $80 of which is FOGEI tax. Under paragraph (c) of this section, the FOGEI tax deemed paid is $46.67 (*i.e.*, $70 × $80/$120). This $46.67 is also FOGEI under § 1.907(c)–2(d)(5) because it must be included in X's gross income under section 78.

Example 2. (i) Assume the same facts as in Example 1. Assume further that in 1983, Z distributes its entire earnings and profits to Y. Y has no earnings and profits during 1983 other than this dividend. Y paid a tax of $50 to S. Assume that Y is deemed under section 902(b)(1) to pay $50 of the tax paid by Z which was not deemed paid by X under section 960(a)(1) in 1983. In 1983, Y distributes its entire earnings and profits to X. Assume that X is deemed under section 902(a) to pay $100 of the taxes actually paid, and deemed paid, by Y.

(ii) Paragraph (b)(1) of this section applies to characterize the $50 tax of Z that Y is deemed to pay under section 902(b)(1). Y is deemed to pay $33.33 of FOGEI tax, *i.e.*, the amount of the tax deemed paid by Y ($50) multiplied by a fraction. The numerator of the fraction is the amount of Z's FOGEI tax ($80) and the denominator is the total taxes paid by Z ($120).

(iii) Under paragraph (a)(8) of this section, a portion of the $50 tax actually paid by Y on the earnings and profits received from Z is FOGEI tax. The amount of tax actually paid by Y that is FOGEI tax depends on the amount of the distribution from Z that is FOGEI (see § 1.907(c)–2(d)(1) (i) and Example 2 (ii) under § 1.907(c)–2(d)(8)). This result does not depend upon whether a portion of the distribution from Z is described in section 959(b) and it follows even though a portion of Y's earnings and profits will be excluded from X's gross income under section 959(a)(1) when distributed by Y. Assume that $12.50 of the $50 tax actually paid by Y is FOGEI tax.

(iv) Under paragraph (b)(1) of this section, X is deemed to pay $45.83 of FOGEI tax by reason of the distribution from Y. This amount is determined by multiplying the total taxes deemed paid by X by reason of such distribution ($100) by a fraction. The numerator of the fraction is the FOGEI tax paid, and deemed paid, by Y ($45.83, *i.e.*, $33.33 under paragraph (ii) of this example plus $12.50 under paragraph (iii) of this example). The denominator of the fraction is the total taxes paid, and deemed paid, by Y ($100). This $45.83 is FOGEI under § 1.907(c)–2(d)(5) because it is included in X's gross income as a section 78 dividend.

Example 3. (i) X, a domestic corporation, has a concession with foreign country Y that gives it the exclusive right to extract and export the crude oil and natural gas owned by Y. The concession agreement and location of the oil and gas wells mandate that X construct a system of pipelines to transport the minerals that are extracted to a port where they are loaded onto tankers for export. X owns the transportation facilities. Y has an income tax system under which income from mineral operations is subject to a 50 percent tax rate. The taxation by Y of the mineral operations is a separate tax base under paragraph (a)(3) of this section. Under this system, Y imposes the tax at the port prior to export and it establishes a posted price of $12 per barrel. Y also collects royalties of $1.44 per barrel (*i.e.*, 12 percent of this posted price) which is deductible in computing the petroleum tax. Y also allows X deductible lifting costs of $.20 per barrel and deductible transporting costs of $.80 per barrel. Y does not allow any credits against the mineral tax. Assume that X does not have any income in Y other than the mineral income. (In 1983, X extracts, transports, and exports 10,000,000 barrels of crude oil, but for convenience, all computations are in terms of one barrel). X pays foreign taxes of $4.78 per barrel, computed as follows:

Sales	.....	$12.00
Royalties	$1.44	.....
Lifting	.20	.....
Transporting	.80	.....
	2.44	(2.44)
Income base	.....	9.56
Tax rate (percent)	.....	.50
Tax	.....	4.78

Assume that these taxes are creditable taxes under section 901, that the fair market value of the oil at the port is $10 per barrel, and that under § 1.907(c)–1(b)(6) fair market value in the immediate vicinity of the oil wells is $9 per barrel. Thus, at the port, the excess of posted price ($12) over fair market value ($10) is $2.

(ii) The $4.78 foreign tax paid to Y is allocated to FOGEI and FORI in accordance with the rules in paragraph (a) (2) through (5) of this section.

(iii) Under paragraph (a)(3) of this section, FOGEI and FORI are subject to foreign taxation under one tax base. This foreign tax is allocated between FOGEI tax and FORI tax in accordance with paragraph (a) (4) and (5) of this section.

(iv) The modified gross income for FOGEI is $11, *i.e.*, fair market value in the immediate vicinity of the well ($9) plus the excess at the port of posted price over fair market value ($2). The modified gross income for FORI is $1, *i.e.*, value added to the oil beyond the well-head which is part of Y's tax base ($10–$9).

(v) The royalty deductions are all directly attributable to FOGEI.

(vi) Under paragraph (a)(4) of this section, the income of each class is determined as follows:

	FOGEI	FORI
Modified gross income	$11.00	$1.00
Deductions:		
Royalties	1.44	0
Lifting	.20	0
Transporting	0	.80
Total	1.64	.80
Net Income	9.36	.20

(vii) Under paragraph (a)(4) of this section, the total tax paid to Y is allocated to FOGEI and FORI in proportion to the income in each class. The calculation is as follows:

FOGEI tax = $4.78 × $9.36/$9.56 = $4.68
FORI tax = $4.78 × $0.20/$9.56 = $0.10

Thus, for the 10,000,000 barrels, the FOGEI tax is $46,800,000 and the FORI tax is $1,000,000.

(viii) The allocation under paragraph (a)(4) of this section, rather than the direct application of stated foreign tax rates to foreign-law taxable income in each class of income (which would produce the same results in the facts of this example), is necessary when a foreign country taxes more than one class of income under a progressive rate structure. See Example 4 in this paragraph (e).

Example 4. Assume the same facts as in Example 3 except that Y's tax is imposed at 40 percent for the first $20,000,000 of income and at 60 percent for all other income. The foreign taxes are allocated under paragraph (a)(4) of this section between FOGEI and FORI in the same manner as in paragraphs (vi) and (vii) of Example 3, as follows:

(1) Taxable income	$95,600,000
(2) Tax:	
(a) 40% of $20,000,000	8,000,000
(b) 60% of $75,600,000	45,360,000
(c) Total tax	53,360,000
(3) FOGEI tax (line 2(c) × $9.36/$9.56)	52,243,680
(4) FORI tax (line 2(c) × $0.20/$9.56)	1,116,320

Example 5. Assume the same facts as in Example 3. Assume further that X refines the crude oil into primary products prior to export and Y imposes its tax on the basis of crude oil equivalences of $12 per barrel, rather than the value of the primary products, to establish port prices. Assume that this arrangement is a pricing arrangement described in section 907(d). Thus, Y does not tax the refinery income. The results are the same as in Example 3 even if $12 per barrel is equal to, more than, or less than, the value of the primary products at the port. See paragraph (a)(5)(vi) of this section.

[T.D. 8338, 56 FR 11073, Mar. 15, 1991]

§ 1.907(d)–1 Disregard of posted prices for purposes of chapter 1 of the Code (for taxable years beginning after December 31, 1982).

(a) *In general*—(1) *Scope.* Section 907(d) applies if a person has FOGEI from the—

(i) Acquisition (other than from a foreign government) or

(ii) Disposition of minerals at a posted price that differs from the fair market value at the time of the transaction. Also, if a seller (other than a foreign government) derives FOGEI upon a disposition described in the preceding sentence, section 907(d) applies to the acquisition by the purchaser whether or not the purchaser has FOGEI. Thus, section 907(d) may apply in determining a person's FORI.

(2) *Initial computation requirement.* If section 907(d) applies to any person, income on the transaction as initially reflected on the person's return shall be computed as if the transaction were effected at fair market value. This requirement applies the first time a person has taxable income derived from either the transaction or an item (such as a dividend described in section 907(c)(3)(A)) determined with reference to that income.

(3) *Burden of proof.* The taxpayer must be able to demonstrate the transaction as it actually occurred and the basis for reporting the transaction under the principles of paragraph (a)(2) of this section.

(4) *Related parties.* Section 907(d) (as a rule of characterization) applies whether or not the parties to the transaction are related. Thus, the excess of the posted price over the fair market value

may never be taken into account in determining a person's FOGEI under section 907(a) but may be taken into account in determining a person's FORI.

(b) *Adjustments*. If a taxpayer does not comply with the initial requirement of paragraph (a)(2) of this section, adjustments under section 907(d) may be made only by the Commissioner in the same manner that section 482 is administered. Correlative and similar adjustments consistent with the substantive and procedural principles of section 482 and §1.482–1(d) apply. However, section 907(d) is not a limitation on section 482. If a taxpayer disposing of minerals at a posted price does comply with the initial computation requirement of this section, adjustments and correlative and similar adjustments consistent with the substantive and procedural aspects of section 482 and §1.482–1(d) shall apply, whether made on the return by the taxpayer or on a later audit. This paragraph (b) does not apply to an actual sale or exchange of minerals made between persons with respect to whom adjustments under section 482 would never apply (but see paragraph (a)(4) of this section).

(c) *Definitions*. For purposes of this section—

(1) *Foreign government*. The term *foreign government* means only the integral parts or controlled entities of a foreign sovereign and political subdivisions of a foreign country.

(2) *Minerals*. The term *minerals* has the same meaning as in §1.907(c)–1(f)(1).

(3) *Posted price*. The term *posted price* means the price set by, or at the direction of, a foreign government to calculate income for purposes of its tax or at which minerals must be sold.

(4) *Other pricing arrangement*. The term *other pricing arrangement* in section 907(d) means a pricing arrangement having the effect of a posted price.

(5) *Fair market value*. The term *fair market value*, whether or not at the port prior to export, is determined in the same way that the wellhead price is determined under §1.907(c)–1(b)(6).

[T.D. 8338, 56 FR 11075, Mar. 15, 1991]

§ 1.907(e)–1 [Reserved]

§ 1.907(f)–1 Carryback and carryover of credits disallowed by section 907(a) (for amounts carried between taxable years that each begin after December 31, 1982).

(a) *In general*. If a taxpayer chooses the benefits of section 901, any unused FOGEI tax paid or accrued in a taxable year beginning after December 31, 1982, may be carried to the taxable years specified in section 907(f) under the carryback and carryover principles of this section §1.904–2(b). See section 907(e) and §1.907(e)–1 for transitional rules that apply to unused FOGEI taxes carried back or forward between a taxable year beginning before January 1, 1983, and a taxable year beginning after December 31, 1982.

(b) *Unused FOGEI tax*—(1) *In general*. The ''unused FOGEI tax'' for purposes of this section is the excess of the FOGEI taxes for a taxable year (year of origin) over that year's limitation level (as defined in §1.907(a)–1(b)).

(2) *Year of origin*. The term ''year of origin'' in the regulations under section 904 corresponds to the term ''unused credit year'' under section 907(f).

(c) *Tax deemed paid or accrued*. The unused FOGEI tax from a year of origin that may be deemed paid or accrued under section 907(f) in any preceding or succeeding taxable year (''excess limitation year'') may not exceed the lesser of—

(1) The excess extraction limitation for the excess limitation year, or

(2) The excess general section 904 limitation for the excess limitation year.

(d) *Excess extraction limitation*. Under section 907(f)(2)(A), the ''excess extraction limitation'' for an excess limitation year is the amount by which that year's section 907(a) extraction limitation exceeds the sum of—

(1) The FOGEI taxes paid or accrued, and

(2) The FOGEI taxes deemed paid or accrued in that year by reason of a section 907(f) carryback or carryover from preceding years of origin.

(e) *Excess general section 904 limitation*. Under section 907(f)(2)(B), the ''excess general section 904 limitation'' for an excess limitation year is the amount

by which that year's section 904 general limitation exceeds the sum of—

(1) The general limitation taxes paid or accrued (or deemed to have been paid under section 902 or 960) to all foreign countries and possessions of the United States during the taxable year,

(2) The general limitation taxes deemed paid or accrued in such taxable year under section 904(c) and which are attributable to taxable years preceding the unused credit year, plus

(3) The FOGEI taxes deemed paid or accrued in that year by reason of a section 907(f) carryover (or carryback) from preceding years of origin.

(f) *Section 907(f) priority*. If a taxable year is a year of origin under both section 907(f) and section 904(c), section 907(f) applies first. See section 907(f)(3)(A).

(g) *Cross-reference*. In computing the carryback and carryover of disallowed credits under section 907(f), the principles of § 1.904–2 (d), (e), and (f) apply.

(h) *Example*. The following example illustrates the application of section 907(f).

Example. X, a U.S. corporation organized on January 1, 1983, uses the accrual method of accounting and the calendar year as its taxable year. X's only income is income which is not subject to a separate tax limitation under section 904(d). X's preliminary U.S. tax liability indicates an effective rate of 46% for taxable years 1983–1985. X has the following foreign tax items for 1983–1985:

	1983	1984	1985
1. FOGEI	$15,000	$20,000	$10,000
2. FOGEI taxes	7,500	9,200	4,200
3. Other foreign taxable income	8,000	5,000	10,000
4. Other foreign taxes	3,200	2,000	3,000
5. (a) Section 907(a) limitation (.46 × Line 1)	6,900	9,200	4,600
(b) General section 904 limitation (.46 × (line 1 plus line 3))	10,580	11,500	9,200
6. (a) Unused FOGEI taxes (excess of line 2 over line 5(a))	600	0	0
(b) Unused general limitation taxes (excess of line 4 plus lesser of line 2 or line 5(a) over line 5(b))	0	0	0
7. (a) FOGEI taxes from years preceding 1983 deemed accrued under section 907(f)	0	0	0
(b) Section 904 general limitation taxes from years preceding 1983 deemed accrued under section 904(c)	0	0	0
8. (a) Excess section 907(a) limitation (excess of line 5(a) over sum of line 2 and line 7(a))	0	0	400
(b) Excess section 904 general limitation (excess of line 5(b) over sum of line 4, lesser of line 2 and line 5(a) and line 7(b))	480	300	2,000
9. Limit on FOGEI taxes that will be deemed accrued under section 907(f) (lesser of line 8(a) and line 8(b)	0	0	400

X has unused 1983 FOGEI taxes of $600. Since the excess section 907(a) limitation for 1984 is zero, the unused FOGEI taxes are carried to 1985. Of the $600 carryover, $400 is deemed accrued in 1985 and the balance of $200 is carried to following years (but not to a year after 1988). After the carryover from 1983 to 1985, the excess section 904 general limitation for 1985 (line 8(b)) is reduced by $400 to $1,600 to reflect the amount of 1983 FOGEI taxes deemed accrued in 1985 under section 907(f).

[T.D. 8338, 56 FR 11079, Mar. 15, 1991]